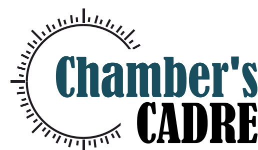
Price ₹ 300/- per copy

No. MCS/149/2022-24 / R.N.I. No. MAHENG/2012/47041 - Total Pages: 152

A Monthly Journal of
**The Chamber of Tax Consultants**




# THE CHAMBER'S JOURNAL

Your Monthly Companion on Tax & Allied Subjects

Vol. XII | No. 4 | Jaunary 2024

## TAX, LEGAL and ACCOUNTING Implications on FINANCIAL INSTRUMENTS

Log on to The Chamber's website for
Online payment for programmes
**www.ctconline.org**

Trezix Ad 1 - 180x250 mm

# Are you a CA managing an IMPEX business? Then this ad is for you.

Say hello to Trezix – a complete import export management software built to help you increase business efficiency and manage your costs better.

Trezix consolidates all first and third party documents, automates functions like FOREX gain/loss calculations, enables easy extraction of reports, offers full break up of Landed Costs and much more. It's designed for minimum human intervention, reducing the scope for errors.

With Trezix, you can effortlessly

- Verify 'cut off' transactions
- Track obligations, licences, scripts, schemes and drawbacks
- Combine multiple GST invoices into a single one
- Make everyday work much more efficient

## Experiencing is believing. Scan for a Demo.

trezix

The easiest way to IMPEX

getintouch@trezix.io    +91 8291946428    www.trezix.io

# CONTENTS

Vol. XII | No. 4 | January 2024

Estd. 1926
ज्ञानं परमं बलम्

**Editorial** — *Vipul Choksi* ........................................................ 5

**From the President** — *Haresh Kenia* ........................................................ 8

## Tax perspective - A Veteran's View Point

Towards a more Beneficent Tax System
— Shri Sohrab E. Dastur........................................11

## SPECIAL STORY — TAX, LEGAL, AND ACCOUNTING IMPLICATIONS ON FINANCIAL INSTRUMENTS

**Company law Implications on the Financial Instruments**
— Radhika Agarwal & Rohan Shrivastava...........15

**Income-tax Implications for various Financial Instruments**
— Chirag Shah & Rohan Umranikar.....................25

**Decoding Financial Instruments: FEMA perspective**
— Vishal Gada & Zeel Jambuwala ........................43

**Financial Instruments & Stamp Duty Implications** — Gopal Malpani .............................59

**Accounting for financial instruments from an Issuer's perspective under IGAAP and Ind AS**
— Siddharth Iyer & Saurabh Mathur....................69

**Navigating the Art and Science of Valuation**
— Paras K. Savla....................................................85

## DIRECT TAXES

**Supreme Court** — Keshav Bhujle .......................105

**High Court** — Jitendra Singh, Radha Halbe & Harsh Shah......................................108

**Tribunal** — Nikhil Mutha, Viraj Mehta & Kinjal Bhuta ..........................................................110

## INTERNATIONAL TAXATION

**Case Law Update**
— Dr. Sunil Moti Lala ............................................121

## INDIRECT TAXES

**GST – Recent Judgments & Advance Rulings** — Naresh Sheth & Jinesh Shah.............125

## CORPORATE LAWS

**Case Law Update** — Makarand Joshi .................133

## OTHER LAWS

**FEMA Update & Analysis**
— Hardik Mehta & Tanvi Vora ............................145

**The Chamber News**
— Neha Gada & Vitang Shah ..............................149

Scan QR code to share feedback

i

**THE CHAMBER OF TAX CONSULTANTS**
3, Rewa Chambers, Ground Floor, 31, New Marine Lines, Mumbai – 400 020
Phone : 2200 1787/2209 0423/2200 2455
E-Mail: office@ctconline.org • Website : http://www.ctconline.org.

# THE CHAMBER'S JOURNAL

**EDITORIAL BOARD 2023-2024**

**Editor**
Vipul Choksi

**Members**
Jayant Gokhale
Keshav Bhujle
Kishor Vanjara
Mahendra Sanghvi
Manoj Shah
Pradip Kapasi

**Ex Officio**
Haresh Kenia (President)
Vijay Bhatt (Vice President)

**Assistant Editors**
Chirag Wadhwa
Fenil Bhatt
Haresh Chheda
Nikhil Tiwari
Rakesh Upadhyay
Sachin Sastakar
Siddharth Parekh
Vikram Mehta
Viraj Mehta
Yatin Vyavharkar

**JOURNAL COMMITTEE 2023-2024**

**Chairman**
Ameya Kunte

**Vice Chairman**
Jiger Saiya

**Ex Officio**
Haresh Kenia (President) Vijay Bhatt (Vice President)

**Convenors**
Bhavik B. Shah • Jagruti Sheth • Toral Shah

**Past President**
K. Gopal • Vipin Batavia

**Office Bearer**
Neha Gada

**Editor**
Vipul Choksi

**Imm. Past Chairman**
Paras K. Savla

**Managing Council Member**
Tejas Parikh

**Members**
Ajay Rotti, Anup Shah
Arpit Jain, Atul Bheda
Bhadresh Doshi, Chintan Gandhi
Janak Vaghani, Jinit Shah
Naresh Ajwani, Ninad Karpe
Pankaj Majithia, Praveen Kumar
Prerana Peshori, Rajkamal Shah
Ritesh Kanodia, Sachin Bangare
Sanjiv Chaudhary, Simachal Mohanty
Vijay Gilda, Vinita Krishnan
Viraj Mehta, Vivek Newatia

**MANAGING COUNCIL 2023-2024**

**President**
Haresh Kenia

**Vice President**
Vijay Bhatt

**Hon. Secretaries**
Neha Gada • Vitang Shah

**Hon. Treasurer**
Mehul Sheth

**Imm. Past President**
Parag Ved

**Editor**
Vipul Choksi

**Members**
Abhitan Mehta, Ameya Kunte
Anish Thacker, Ankit Sanghavi
Ashok Mehta, Ashok Sharma
Dharan Gandhi, Dinesh Tejwani
Hemang Shah, Hinesh Doshi
Jayant Gokhale, Ketan Vajani
Kirit Dedhia, Kishor Vanjara
Mahendra Sanghvi, Niyati Mankad
Paresh P. Shah, Premal Gandhi
Tejas Parikh

**Special Invitees**
K. Gopal
Hitesh R. Shah

**DISCLAIMER**

*Opinions, views, statements, results, replies, etc., published in the Journal are of the respective authors/contributors. Neither The Chamber of Tax Consultants nor the authors/contributors are responsible in any way whatsoever for any personal or professional liability arising out of the same.*

*Non-receipt of the Journal must be notified within one month from the date of publication, which is 12th of every month.*

*No part of this publication may be reproduced or transmitted in any form or by any means without the permission in writing from The Chamber of Tax Consultants. No part of the contents of the Journal should be used as, or be regarded as a substitute for, professional advice.*

***READER'S SUGGESTIONS AND VIEWS**: We invite the suggestions and views from readers for improvement of The Chamber's Journal. Kindly send your suggestions on office@ctconline.org.*

**ADVERTISEMENT RATES**

**Per Insertion**

| | |
|---|---|
| Fourth Cover Page (Colour) | ₹ 15,000 |
| Second & Third Cover Page (Colour) | ₹ 13,500 |
| Ordinary Full Page (B&W) | ₹ 7,500 |
| Ordinary Half Page (B&W) | ₹ 3,500 |
| Ordinary Quarter Page (B&W) | ₹ 1,750 |

(Special discount on bulk inside colour pages)

**DISCOUNT**
25% for 12 insertions
15% for 6 insertions
5% for 3 insertions

Exclusive of GST
Full advertisement charges should be paid in advance.

**MEMBERSHIP FEES & JOURNAL SUBSCRIPTION — FOR THE F.Y. 2023-24**

| Sr. No. | Membership Type | | Fees | GST 18% | Total |
|---|---|---|---|---|---|
| 1. | Life Membership Fees | ₹ | 15,000 | 2,700 | 17,700 |
| 2. | Ordinary Membership Fees - Yearly (April to March) (Hard Copy) | ₹ | 2,500 | 450 | 2,950 |
| 3. | Ordinary Membership Fees - (April To March) – with Soft Copy of Journal (E- JOURNAL) | ₹ | 1,500 | 270 | 1,770 |
| 4. | Admission Fees - Ordinary Membership | ₹ | 750 | 135 | 885 |
| 5. | Associate Membership - Yearly (April to March) | ₹ | 7,500 | 1,350 | 8,850 |
| 6. | Admission Fees - Associate Membership | ₹ | 1,000 | 180 | 1,180 |
| 7. | Student Membership - Including E-Journal (April to March) | ₹ | 500 | 90 | 590 |

**CHAMBER'S E-JOURNAL SUBSCRIPTION — FOR THE F.Y. 2023-24**

| Membership Type | Fees | GST 18% | Total |
|---|---|---|---|
| **(HARD COPIES)** | | | |
| Journal Subscription - Life Members | 1,350 | 0 | 1,350 |
| Journal Subscription - Non Members | 2,500 | 0 | 2,500 |
| Journal Subscription - Student Members | 1,000 | 0 | 1,000 |
| **(SOFT COPIES)** | | | |
| E Journal Subscription - Life Members (Yearly) | 700 | 126 | 826 |
| E Journal Subscription - Non Members (Yearly) | 1,000 | 180 | 1,180 |
| E Journal Subscription - Single Journal | 200 | 36 | 236 |

ii

# Editorial

Dear Readers,

As 2023 draws to a close, one cannot help but look back at the year that was full of significant shaping global events which have impacted India, and trust me, there's a lot to look forward to.

The global events of 2023 have surely given India an edge and a leverage over the rest of the world. Whether it is the ongoing geopolitical turbulence causing global disruption, the Russia-Ukraine war, the Israel-Hamas war, the ongoing trade wars with China, these have not only impacted global business at large but also their impact trickles down to the common citizens too, in its own way..

Amidst all this, the silver lining is that the world is starting to perceive India as a safe haven and this has resulted in the attracting of companies from the world over including big giants like Apple and Tesla, who are willing to shift at least some of their manufacturing activities to India.

And what's even better, is that with the Government's concentrated efforts on it's famous (and rightly so) "Make In India" campaign, we have embarked on the journey to become a global manufacturing powerhouse.

India's aim for self-sufficiency is definitely turning the wheels of economic growth rapidly, positioning us at a pivotal juncture, both on the domestic and global fronts. India stands before the world as a relatively stable destination to invest and set up shop in some form or the other.

Over and above the global impact, India has had a lot to celebrate in 2023 - two successful space missions, a new Parliament house, the Supreme Court decision upholding the government's decision to repeal Article 370 of the Constitution which granted a special status to the former state of Jammu and Kashmir, an effective rescue mission to drill out people stuck inside Sikyara tunnel, passing of women's reservation bill, the list goes on… How can we

forget that our G20 Presidentship witnessed unparalleled success and that the Indian economy continued to record a robust GDP growth of 6 to 7% throughout the year? Let us hope and wish that the New Year, 2024 is even more eventful and India continues to grow and progress towards its journey to become one of the strongest economies of the world during Amritkaal!

While I've highlighted the global scenarios and their impact on India in 2023, I would like to draw everyone's attention to a very important development of the past year which cannot be left unrecognised, that is the pervasion of is Artificial Intelligence (‘AI’) in our daily lives. The increased use of AI made 2023 a year of massive evolution for the Information Technology industry, as generative AI technologies reached new levels of impact and performance.

This year was all about people figuring out the ‘what’ and ‘how’ of this technology and its impact on us, be it the good, the bad and the ugly!

The latest data shows that use of generative AI has been significant and it's usage is reaching peak hype. AI uses and functions have also shifted over the past 12 months. So what might come in 2024 and beyond?

- Chat GPT was initially just a chatbot that could generate text. Now, it can generate text, images and audio.
- Earlier, AI struggled with rendering human hands and limbs. By now, AI generators have markedly improved on these tasks.
- Deploying deepfakes of people for mimicking or fraudulent purpose
- A technology expected to evolve significantly is Metaverse (a virtual-reality space in which users can interact with a computer-generated environment) which is expected to be adopted by many industries such as healthcare, education, consumer, entertainment etc.
- Emergence of Indian Large Language Models (LLMs). The upcoming AI models in Indian languages aims to break the language barrier. This will have an industry wide impact on diverse industries. For example, it will empower farmers with accurate weather forecast availability and students to learn the local dialects.

AI will be an integral part of every human’s day to day routine, and especially that of the working class. Needless to say that it will continue to haunt us with multiple issues such as unemployment, data privacy, deep faking , copyright issues, etc.

India is at the cusp of being one of the largest economies of the world with consistent and stable growth. There have been all around corporate growth stories and booming stock market

says it all. All the corporates have been looking to raise funds by way of IPOs ,Right issues, bond issues etc. Financial market being very dynamic various types of financial instruments keep developing some of them being quite complex.

There are multiple issues which an entity or professional needs to deal with, such as accounting, direct and indirect tax, FEMA, SEBI and Companies Act ,2013 etc while dealing with financial instruments. The Journal Committee therefore has rightly thought of coming out with an issue on Financial Instruments titled "Tax, Legal, and Accounting Implications on Financial Instruments". Special mention and compliments to the Journal Committee members Arpit Jain and Vijay Gilda who have conceptualised and decided the sub topics of this issue. I would like to express my gratitude to all the experts on the subject for sparing their valuable time and sharing their knowledge through their incisive articles.

The Journal Committee has started a new column titled ***"Tax Perspectives: A Veteran's View Point"*** from this issue of the Journal. This column will be published once in three months and will be authored by Tax Luminaries. I am very happy to inform that the first article of this series, **"Towards a more beneficent tax system"** is authored by none other than, the very respected Senior Advocate and Past President of Chamber, Shri Sohrab E. Dastur. My compliments to the Journal Committee for this initiative.

Though the beginning of 2024 signifies a new chapter for one's dreams and aspirations, I wish that your journey through 2024 be marked by exciting adventures and fulfilling experiences. May you find balance in your life and take time for self-reflection and self-care.

May this year be filled with prosperity, hope, positivity and excitement for you. Wishing you moments of serenity and mindfulness.

Wishing you and your family Happy Pongal and Happy Makar Sankranti

**VIPUL K. CHOKSI**
*Editor*

v

# From the President

Dear Members

As we step into the New Year, I extend my warmest wishes to you all for a joyous and prosperous year ahead. This occasion is not just about celebrating but also about planning for what lies ahead and reflecting on the past year. Let's embrace the fresh opportunities and learnings this New Year brings, and may it be filled with happiness, success, and growth for each of you.

As month of December/January unfolds, we traditionally find ourselves immersed in pre-budget preparations, analysing potential fiscal policies and their implications. However, this year presents a different scenario due to the upcoming elections. Instead of a formal budget, the government will present a 'Vote on Account.' This interim arrangement, while not as comprehensive as a full budget, still warrants our attention and analysis. This interim measure is a precursor to the full budget, which will be presented post-election. This adjustment in fiscal proceedings calls for our attention to the nuances of this temporary arrangement, while also keeping an eye on the horizon for the detailed budgetary planning that will follow the elections.

Pleased to discuss "Revolutionizing India's Legal Landscape: The Impact of New Legal Reforms" through the introduction of the Bharatiya Nyaya Sanhita (BNS), 2023, Bharatiya Nagarik Suraksha Sanhita (BNSS), 2023, and Bharatiya Sakshya Adhiniyam (BSA), 2023. These reforms represent a significant stride towards modernizing our legal system, aligning it with contemporary needs and global standards.

The BNS, 2023, marks a significant shift from the traditional Penal Code, streamlining legal processes by reducing the number of sections and focusing on key societal concerns like the protection of women and children. This reform demonstrates a forward-thinking approach, incorporating contemporary punishments like community service and extending legal jurisdiction beyond national borders to reflect our interconnected world. Similarly, the BNSS, 2023, replacing the Code of Criminal Procedure, brings uniformity

to the judicial structure across the country. This act significantly integrates technology into legal proceedings, transforming everything from the issuance of summons to the collection of evidence. It also places a heightened emphasis on the rights of victims and the elderly, showcasing a compassionate and humane approach to justice. Furthermore, the empowerment of special executive magistrates under this act is a testament to our commitment to more efficient legal procedures and faster trials. The BSA, 2023, which supersedes the Indian Evidence Act, is a leap towards adapting to the digital age. By acknowledging electronic and digital records as valid forms of evidence, it addresses the shift from traditional paper-based documentation to digital data storage and communication. This act not only expands the scope of expert evidence but also establishes clear guidelines for the admissibility and authenticity of electronic records. The modernization of the legal language, removing archaic terms, aligns the Act with the contemporary legal and societal context. Collectively, these reforms showcase our efforts to create a more inclusive, technologically adept, and streamlined legal system. They address contemporary challenges such as digital evidence, the dynamics of global crime, and the need for reformative justice. These changes are not just about updating laws; they are about transforming the very way justice is perceived and delivered in our country. As we move forward, these reforms will play a pivotal role in enhancing the efficiency, fairness, and modernity of the Indian legal framework. We are witnessing a historic moment in the evolution of our legal system, one that promises a future where justice is more accessible, responsive, and in tune with the times.

The recent launch of 'Viksit Bharat @2047: Voice of Youth' by Prime Minister Shri Narendra Modi is not just a milestone in India's developmental journey, but a clarion call to our professional community. This initiative is an open invitation for us to be at the forefront of shaping India into a developed nation by 2047, leveraging our unique skills and expertise. Our role in this national movement transcends our everyday professional responsibilities. It’s an opportunity to mentor and collaborate with the youth, infusing their innovative ideas with our practical and seasoned insights. This synergy is crucial for creating policies that are not only visionary but also realistic and applicable, addressing the core sectors of our economy and governance. The Prime Minister’s emphasis on educational institutions as the nurturing ground for innovation highlights our duty to guide the next generation. The Ideas Portal is a key instrument in this endeavor, where our collective wisdom can meet the vibrant ideas of young minds, crafting policies that are inclusive, robust, and sustainable.

Commercial and Allied Laws Committee, is organizing a comprehensive webinar on "Tax, Accounting and Secretarial Implications Arising Post Acquisition under IBC (Insolvency and Bankruptcy Code)." Scheduled from February 2, this virtual program is tailored to address the evolving complexities of the IBC, 2016, especially in the context of post-acquisition scenarios. This event promises a comprehensive overview of the challenges and opportunities within IBC, offering insights from distinguished speakers with deep

expertise in these fields. This webinar isn't just a learning session; it's an essential tool for professional development, keeping you abreast of current trends and sharpening your skills in a complex legal and financial environment. I highly recommend our members to seize this opportunity for growth and advancement in our dynamic industry.

Accounting & Auditing Committee's upcoming lecture meeting in the Internal Audit series, focusing on the "Changing Landscape of Internal Audit." Scheduled for January 17, this will be led by the Mr. Satish Shenoy, a renowned expert in Internal Audit. This lecture aims to illuminate the significant shifts occurring in Internal Audit practices, addressing critical topics such as the need for agility, traditional versus modern approaches, risk-based auditing, and the role of technology. It's designed to offer valuable insights for both seasoned and aspiring internal auditors, as well as students setting their sights on a career in this field. I encourage our members to join this enlightening session to stay at the forefront of internal audit knowledge and practice.

Thrilled to announce the "Workshop on GST Law," a collaborative initiative jointly organized with AIFTP (WZ), BCAS, MCTC, and WIRC of ICAI. This virtual workshop, scheduled to commence on January 16, 2024, and extend until February 27, 2024, continues the tradition established since 2009 by the GSTPAM of fostering knowledge and expertise within the professional community. Excited to host a comprehensive series spanning 12 sessions plus a special Mega Brain Trust session. Designed to tackle both theoretical and practical aspects of GST, including interpretation challenges, this workshop is an invaluable resource for professionals dealing with indirect tax matters, keeping them abreast of the latest developments in the GST landscape.

The Study Circle and Study Group Committee announces a Study Circle Meeting on "Select Issues with Reference to Taxation of Transactions in Immovable Property." This session, set for January 15, 2024, will be conducted in a hybrid mode, offering both in-person and virtual participation options

I'm excited to present our newest journal edition centered on "Tax, Legal, and Accounting Implications on Financial Instruments," masterfully curated by our Journal Committee Chairman, Shri Ameya Kunte. This edition is a comprehensive resource, offering invaluable insights for our members. My sincere thanks to all contributors and the dedicated committee for their exceptional work in bringing this critical topic to the forefront.

With best wishes,

**HARESH KENIA**
*President*

viii

**Shri Sohrab E. Dastur**
*Senior Advocate*

## TOWARDS A MORE BENEFICENT TAX SYSTEM

A "beneficent system of taxation" is a system of taxation which is just and beneficial to the payer, i.e., the assessee as well as to the recipient of the tax, i.e., the Government. The two are in a sense complementary to one to another: the State would not be able to provide its citizens the security, amenities, the infrastructure and an organized form of society which ensures that might is not right, without the taxpayer providing to the State the wherewithal with which do so in the form of honest payment of taxes by him. Justice Holmes of the U.S. Supreme Court very succinctly stated "I love to pay my taxes because with them I buy civilization". The cynic may, of course, say that if civilization is what an assessee sees around him he would rather have the option not to buy it!

For the taxpayer a beneficent system of taxation implies a system under which the State collects from him fairly and with an even hand what is properly due and the system has provision for swift redressal of his grievances. People who do not honour their tax commitment to the State attempt to rationalize their wrong doing by execuses to the effect that there is so much waste and corruption in the Government machinery that an assessee is justified in not paying to Caesar his dues. This is a lame justification for bad citizenship. Justice Sabyasachi Mukharji of the Supreme Court of India (who later become Chief Justice) observed in anguish in *CWT II vs. Arvind Narottam* (1988) 173 ITR 479, 487 "But the question which many ordinary taxpayers very often, in a country of shortages with ostentatious consumption and deprivation for the large masses, ask is, does he with taxes buy civilization or does he facilitate the waste and ostentation of the few. Unless waste and ostentation in Government spending are avoided or eschewed, no amount of moral sermons would change people's attitude to tax avoidance." If a taxpayer is assured that the State will take action against the politically powerful as swiftly and effectively as against the ordinary

citizen it would to a great extent inculcate in him an attitude which leads to better compliance. What is necessary is to create an atmosphere of tax compliance and to generate the feeling that the assessing Officer will faithfully and honestly discharge his duty.

Even handed and fair tax administration to a large extent helps to create a more beneficent system of taxation both for the State and the subject. The avoidance of delay in the justice delivery system is an important factor in this behalf. It is unfortunate, but true, that delay in any judicial process, is to the advantage of the dishonest. If a dispute takes 15 to 20 years for a final judicial resolution it only means that the person in the wrong continues to enjoy his ill-gotten advantage for that period.

Such delay can be lessened, if a larger number of adequately qualified persons are engaged in implementing our tax administration system. This in its turn entails the grant of adequate remuneration and other facilities to person engaged in administration of our tax system so as to induce more and adequately qualified persons to join the adjudication system. A large part of the delay in tax administration is caused by the fact that the Tribunal, Board or Court, as the case may be, is burdened with what is avoidable litigation. If there is a system whereunder the Assessing Officer is more effectively made accountable for the quality of his assessments, litigation would considerably reduce. The awarding of costs which have a relation to what the injured party has had to incur in fighting the litigation and the invisible cost in the form of time spent because of the litigation is necessary. The fact that there is a power to award costs (and which is appropriately exercised) would act as a good deterrent to fomenting of unnecessary litigation.

Sometime in over enthusiasm the State announces a reward if the action of a tax official has resulted in an assessee having to pay a larger tax. It is said that the holding out of such a bait induces greater diligence in the performance of an Officer's duties. This is a short sighted policy. A tax officer discharges a quasi judicial function and is supposed to hold the balance equal between the State and its subjects. Such an equitable holding of the balance is frustrated if one of the parties to the issue involved (the Union Government) holds out the bait of a reward to the Officer if he acts in a particular manner.

A cardinal principle of law is that for every wrong there should be a remedy. The tax system will be beneficent if an assessee is entitled to appeal to the prescribed authority against all decisions of an assessing officer which are prejudicial to him and not only against orders of the Officer which are specified in section 246/246A of the Act as at present. This will avoid a litigation which often arises today: as the whether the Officer's order is appealable.

The effective repealing of the provision of Chapter XXA and XXC (conferring power on the Central Government to acquire immovable properties) and the constitution of the Settlement Commission (vide Chapter XIXA) were steps which made the tax system more beneficent.

The Income-tax Act, 1961, has been in operation from the assessment year 1962-63, i.e., as of date, for 64 years. It has undergone wide ranging changes effected by several Finance Acts as well as Income tax Amendment Acts: When framed, the 1961 act consisted of 298 sections and five Schedules. Though, as of to-day, the last section is still numbered "298" almost over 450 sections (which still survive), have been added in the Act after 1961 by alphabetic additions to the Arabic numbered sections. For example, we now have section 80 HHBA, i.e., 4 sections alphabetically numbered have been added after section 80 and before section 81! 34 of the originally enacted sections have been omitted, so also some sections enacted after 1961! New Schedules have been added so that the Act now has 14 schedules. On account of the several changes periodically made in the 1961 Act. the framing of a new consolidating Act would undoubtedly be beneficent. However, one drawback in so doing is that in framing the new Act, the wording of a section may undergo a change. As of today, the High Courts and Supreme Court have opined on the interpretation of a majority of the sections in the Act and have clarified what their wordings mean. If in the contemplated new Act the wording of a section is changed it may lead to protracted litigation to determine the exact effect and significance of the changed wording.

To make the tax system beneficent it is for consideration whether the provisions of Chapter XA (incorporating the General Anti Avoidance Rule) should be restricted and specifically rendered inapplicable to issues arising under a bilateral Double Taxation Avoidance Agreement. Otherwise one implicity accepts that a party to an agreement (India) can unilaterally decide what is the meaning of the words used in the Agreement.

For the lay assessee the determination of the capital gain made by him on transfer of, say, financial assets,: a) listed shares and units of equity oriented mutual funds b) unlisted shares and c) listed units of real estate investment trusts and infrastructure investment trust in which he has invested his surplus funds is very complicated. For each type of financial asset to qualify as a long term capital asset different holding periods are prescribed (12 months, 24 months and 36 months) and the rates of tax applicable vary from 10 to 30%.

In arriving at the quantum of the capital gain the cost of acquisition of the asset transferred is to be deducted. Such cost in its turn depends on the nature of the asset, the manner or method of its acquisition by the assessee or by the person from whom the assessee acquired the asset, the time of its acquisition, the fair market value of the asset on a prescribed date, the availability of indexation etc. The manner of determining the cost of acquisition of an asset covers 5 closely printed pages in the 68th Edition (2023) of Taxmann's Income-tax Act!

If the asset is not held for the prescribed period it will be a short term capital asset. The manner of determining the tax liability on the transfer of short term/long term capital assets is different and so also the manner of set off of a loss on the transfer of a capital asset against a subsequent

capital gain. The tax system will be rendered beneficent if the manner of ascertaining the quantum of a capital gain made by an assessee and its treatment is simplified.

The making of faceless assessments and the disposal of appeals in a faceless manner are the hot topics of the day. There are contradictory views: those who assert that it is a great innovation and those who opine that "faceless is useless." In order to determine which view is correct, it may be beneficent, both for the tax administrator and the assessees if, before the matter goes completely out of hand, a high powered committee consisting of tax officials, representatives of associations of tax professionals and some outstanding individuals is constituted to opine on the issue. The Committee will undoubtedly bear in mind what has been stated as the reason for the introduction of faceless assessments. When presenting the final budget for 2019-20 the Finance Minister in paragraph 124 of her speech (415 ITR 1,25 (st)) stated "The existing system of scrutiny assessments in the Income-tax Department involves a high level of personal interaction between the tax-payer and the Department, which leads to certain undesirable practices on the part of tax officials. To eliminate such instances. .... a scheme of faceless assessment in electronic mode involving no human interface is being launched ..."

The Committee's opinion may specifically be sought as to whether the abandoning by the Union Government of procedures, which have evolved over more than a 100 years, is the most appropriate way to tackle corruption apparently indulged in by its employees or should one evolve other more effective measures to get rid of corruption without getting rid of a system which has been acclaimed.

In conclusion I may only express the hope that a conscientious reader of the Chamber's magazine does not feel that the non-publication of this article would have been beneficent for all concerned!

# Company Law Implications on the Financial Instruments

Radhika Agarwal
Advocate

Rohan Shrivastava
Advocate

**Overview**

*In this article, we have highlighted key features of common types of instruments which can be issued by a company under Indian company law. Broadly, a company can raise funds through raising capital or borrowing funds as loan or availing deposits. For raising capital, under Indian company law, a company may issue two kinds of shares, namely: (a) equity share capital with voting rights; or with differential rights as to dividend, voting etc; and (b) preference share capital with preference in receipt of dividend and the liquidation proceeds. Indian company law provides flexibility to shareholders to structure the share capital depending on their capital requirement via an appropriate mix of equity shares and preference shares. For debt financing, a company may avail loans from banks, financial institution or other investors or issue debentures in lieu of the monies borrowed.*

*A limited liability company can also issue various kinds of hybrid instruments like optionally convertible preference shares, compulsorily convertible debentures, and optionally convertible debentures. As the name suggests, compulsorily convertible debentures must necessarily convert into equity shares and cannot be redeemed, and the optionally convertible preference shares and optionally convertible debentures have the flexibility to either convert into equity shares or be redeemed. The mechanics and the principles relating to the conversion and redemption of these hybrid instruments are contractually negotiated. Other than the above, Indian company law also provides that a company can issue share warrants, which are the instruments in the nature of options and gives rights to the holder to subscribe to the equity shares of the company at a pre-determined price, and at an agreed time.*

*This article discusses the kinds of instruments (along with key features) and nuances around issuance, transfer, redemption of these instruments under Indian company law.*

## A. Introduction

The (Indian) Companies Act 2013 ("Companies Act") introduced a significant overhaul to the regulatory framework governing corporate entities in India. Among its various provisions, the Companies Act delineates a comprehensive set of instruments that companies can use to structure their capital, manage ownership, and facilitate financial transactions. The Companies Act provides for various instruments that companies can issue for raising capital. The common types of instruments are: (a)

SS-IV-1

Equity Shares; (b) Preference Shares; and (c) Debentures. The Companies Act provides flexibility for companies to issue instruments like equity shares with differential voting rights, compulsorily convertible preference shares, redeemable preference shares, non-convertible debentures, optionally convertible preference shares, compulsorily convertible debentures and share warrants.

## B. Kinds of Instruments

### 1. Equity Shares

*Key Features:* Equity shares, also known as ordinary shares or common shares, represent ownership in a company and provide the shareholder with a claim on a portion of the company's assets and profits. In financial terminology, equity shares are referred to as 'risk' capital which confers on the equity shareholders the residue to the rights of the company which have not been conferred on other classes of shares. Equity shares also carry statutory voting rights. In a nutshell, equity share represents a unit of ownership in a company. As the terminology suggests, equity shares issued by a company forms a part of the equity share capital.

***Kinds of Equity Shares:*** Under the Companies Act, equity shares are further sub-divided into two kinds, namely (i) equity shares with voting rights; and (ii) equity shares with differential rights as to dividend, voting or otherwise.

(a) **Ordinary equity shares with voting rights:** Equity shares with voting rights are considered ordinary shares and do not have any special right attached to them. The voting rights in respect of such shares are in proportion of shares in the paid-up share capital of the company. A shareholder can exercise its vote in one of the following ways: (i) by show of hands, (ii) by electronic means, (iii) by poll, or (iv) by postal ballot.

(b) **Equity Shares with Differential Rights**: Equity shares with differential rights may have a combination of the following different rights:

(i) *Voting rights*: Equity shares with differential voting rights may have higher or lesser voting/management rights as compared to the ordinary equity shares. That said, equity shares with differential rights are different from equity shares with no voting rights. The Companies Act confers voting rights upon every member of a company limited by shares and holding any equity share capital. Therefore, voting rights of all classes have to be maintained though they may be of differential nature. Voting for shares with differential voting rights can be made effective only through a poll.

(ii) *Dividend rights:* As with the voting rights, equity shares with differential dividend rights are those equity shares pursuant to which the shareholders receive dividend, which is less or more than the dividend payable by the company to other equity shareholders.

(iii) *Other rights:* The Companies Act does not clarify the scope of the expression 'otherwise' as set out in Section 43 of the Companies Act 2013 as set out below:

*"43(a) The share capital of a company limited by shares shall be of two kinds, namely…*

*(ii) with differential rights as to dividend, voting or otherwise in accordance*

> *with such rules as may be prescribed"*

As such, 'otherwise' may include any other right attached to equity shares; for instance, right of participation in management or differential rights when the company enters a scheme of arrangement or amalgamation or right to participate in profits for one particular division of the company.

## 2. Preference Shares

***Key Features:*** As the name implies, preference shares carry some preferential rights over the other class of shares, particularly in relation to equity shares. The preference shares must satisfy the following two conditions, in the absence of which such instrument cannot be classified as preference shares: (i) it must carry a preferential right to a fixed amount, or an amount calculated at a fixed rate; and (ii) in the event of a winding-up or other arrangement to repayment of capital, there must be a preferential right to be repaid the amount of capital paid-up on such share. In addition to the above-mentioned conditions, preference shares may also include other terms and conditions like the right to participate in additional profits or capital. While the features of a preference share are different from an equity share and may appear to be closer to a debenture, preference shareholder is only considered a shareholder of a company and cannot exercise the rights of a creditor like making a claim on the money due on the shares undertaken to be redeemed or claim a return of their investment except in case of winding-up. The terms and conditions of the issuance of such preference shares are typically agreed upon contractually.

***Voting Rights:*** With respect to voting on preference shares, the Companies Act prescribes that the holders of preference shares have a right to vote on any resolution of the company where the matter under vote directly affect their rights as a preference shareholder or where matter under vote relates to winding up of the company or the matter is in relation to repayment or reduction of share capital (whether equity or preference) of the company. Preference shareholders may get a right to vote on all resolutions of the company at any meeting (irrespective of the conditions mentioned above) if the dividend payable to preference shareholders is in arrears for an aggregate period of not less than two years.

Set out below are some additional features of preference shares:

(i) **Accumulation of arrears of dividend:** Preference shares can be cumulative or non-cumulative. Cumulative preference shares are those where the arrears of preference dividend get accumulated. Any unpaid dividend is added to the amount payable the following year and no dividends can be paid on ordinary shares until the entire backlog of unpaid dividends on cumulative preference shares is cleared. Non-cumulative preference shares do not accumulate dividends that are in arrears.

(ii) **Redeemability:** Redeemable preference shares are required to be redeemed within twenty years from the date of issue, with specific exemption being granted for issuance by companies engaged in infrastructure projects.

(iii) **Convertibility**: Preference shares which are convertible into equity shares at a later date are known as convertible preference shares. Whereas preference shares which cannot be converted into equity shares and are redeemed in terms of their issue are known as redeemable preference shares. Convertible preference shares are required to be converted within twenty years from the date of issue, with specific exemption being granted for issuance by companies

engaged in infrastructure projects. Convertible preference shares can be further sub-divided into compulsorily convertible preference shares and optionally convertible preference shares, depending upon the terms of their issuance.

### 3. Debentures

***Key Features:*** Debentures are financial instruments issued by a company for a specified tenure with a promise to pay interest to the holder of the debentures. Debentures could be in the form of bonds or any other instrument of a company evidencing a debt, whether constituting a charge on the assets of the company or not. Company is liable to pay interest on the outstanding debentures, whether there are profits or not. Unlike shares, debentures do not carry any statutory voting rights.

***Kinds of Debentures***

Set out below are some additional features of debentures:

(i) **Security**: Debentures can either be secured or unsecured. In case of secured debentures, security is created via a charge on the assets of the company or its subsidiaries or its holding company or its associate companies, for a value which is sufficient for the due repayment of the amount underlying debentures and interest thereon. The security for the debentures is created in favour of the debenture trustee by way of a charge or mortgage. On the other hand, in cases of unsecured debentures, no such charge is created on any property or asset of the company. Notably, a company cannot issue secured debentures which are redeemable beyond a period of ten years. However, Companies Act provides exemption for companies engaged in infrastructure projects or infrastructure finance companies or infrastructure debt fund non-banking financial companies, in which case redemption period can be up to thirty years.

(ii) **Convertibility**: A company may issue debentures which are either compulsorily convertible into equity shares or optionally convertible into equity shares (either wholly or partly at the time of redemption) or which cannot be converted into equity shares at all. While compulsorily convertible debentures are issued under Section 71 of the Companies Act 2013, certain features of a debenture do not apply to compulsorily convertible debentures, for instance, a company issuing compulsorily convertible debentures is not required to create a debenture redemption reserve, which is otherwise required to be created by a company issuing non-convertible debentures convertible debentures.

### 4. Share Warrants

***Key Features***: Share warrants are written options to subscribe to the shares of a company on pre-agreed terms at a future date. While issuance of share warrants is not directly covered under the Companies Act, these are treated as security and referred in few instances under the Companies Act. There is no explicit provision under the Companies Act that prohibit the issuance of share warrants by unlisted companies and since these can considered as 'security', a company may issue share warrants, whether listed or unlisted, in compliance with applicable law.

Companies Act does not prescribe a maturity period for share warrants or sets out the definitive time period between which the warrants get converted into equity shares. Until the time the warrants are exercised, and equity shares are issued to the warrant

holders, none of the rights of an equity shareholder shall be available with a warrant holder. That said, it may be possible for a warrant holder to negotiate certain rights (like a reserved matter right wherein certain actions by the company shall require prior approval of the warrant holder) and include such rights in the articles of association of a company. Companies Act is also silent on the pricing or formula for conversion of share warrants into equity shares.

**C. Issuance of Instruments**

An issuance of shares can be made by the company either at face value or at a premium over the face value. Issuance of shares at discount is prohibited under Companies Act. Typically, a holder of an instrument subscribes to shares by payment of consideration in form of cash. However, under Companies Act a company is permitted to issue shares for consideration other than cash subject to compliance with prescribed conditions. The consideration other than cash can be in various forms, illustratively: (a) in the form of assets (like any intellectual property or machinery or equipment or technical know-how); or (b) against pre-incorporation expenses.

1. ***Issuance of Equity Shares:*** Companies Act sets out how a public company or a private company may issue securities. Illustratively, a public company may issue securities through public offer of securities or private placement of securities or rights issuance or bonus issuance. On the other hand, a private company may issue securities through private placement or rights issuance or bonus issuance. In addition to these, a company may also issue securities to its employees under a scheme. These modes of issuances are briefly discussed below:

(i) **Public Offer:** In case of public offer, securities of a company are offered to public at large by issuance of a prospectus by the issuing company. Public offer of securities includes initial public offer, further public offer and offer for sale of securities to the public by an existing shareholder. While the Companies Act 2013 provides for conditions for making a public offer, since the public offer involves issuance of securities to public at large and the securities issued get listed on stock exchanges, Securities and Exchange Board of India (the regulator of listed securities) governs the regulatory framework for public offer of securities.

(ii) **Private Placement:** It is one of the most common modes of raising private funding. Private Placement involves offer of securities or an invitation to subscribe to securities or issuance of securities being made to a select group of persons by a company other than by way of public offer. Unlike a public offer, an offer for private placement is made by way of a private placement offer cum application which satisfies the conditions set out in Sections 42 and 62(1)(c) of Companies Act 2013. To keep the offering private, a company can make a private placement offer to not than 200 persons in aggregate in a financial year. However, in computing such 200 persons, qualified institutional buyers and employees of the company to whom securities are being offered under an Employee Stock Option Scheme already issued

are excluded. The price at which shares are issued under private placement route needs to be based on the valuation conducted by a registered valuer and in case of listed companies, such issuances are required to comply with the relevant regulations of Securities and Exchange Board of India. If the company issues share for consideration other than cash, the company is required to procure a valuation report determining the value of the shares issued for consideration other than cash confirming that the shares being issued are commensurate with the contribution being made.

(iii) **Rights Issuance:** Right issuances involve issuance of shares by a company to its existing equity shareholders as on the date of the offer. Unless otherwise prescribed under the articles, in case of rights issuance, shares are offered in proportion to the paid-up share capital. The offer is made through an offer letter and complying with the conditions set out in Section 61(1)(a) of the Companies Act 2013.

(iv) **Issuance under Employee Stock Option:** A company may also issue shares to employees under a scheme of employee stock option (also known as ESOP). Under a scheme of ESOP, option is given to directors, officers and employees of a company or its holding company or its subsidiary company which gives such directors, officers and employees the benefit or right to purchase or subscribe the shares of a company at a future date at a pre-determined price. No option can be granted to an employee who is a promoter or belongs to promoter group or a director who holds more than ten percent of the paid-up share capital of the company. The issuance should comply with conditions set out in Section 62(1)(b) of the Companies Act 2013.

(v) **Bonus Issuance:** If a company is prosperous and accumulates a large surplus, it may convert this surplus into capital and divides the capital among the members in proportion to their rights and such issuance is known as bonus issuance. A bonus issuance is done by issuing fully paid shares representing the increased capital. In case of issuance of fully paid-up bonus shares, the profits of the company are capitalised and the existing shareholders, instead of receiving any moneys out of the undistributed profits only, receive pro rata fresh shares. Bonus shares can be issued to its members by a company out of its free reserves or security premium account or capital redemption reserve account. Issuance of bonus shares in lieu of dividend has been prohibited.

2. ***Issuance of equity shares with differential rights***: With respect to issuance of equity shares with differential rights, a company is required to comply with the conditions set out in Rules 4(1) of the Companies (Share Capital and Debentures) Rules 2014, which inter alia requires: (a) the articles of the company to authorise such issuance, (b) the shareholders of the company approving such issuance, (c) the company not having defaulted in filing annual financial statements and

annual return during the immediately preceding three financial years from the financial year in which issuance is being made, (d) there being no subsisting default in the payment of a declared dividend to its shareholders or repayment of its matured deposits or redemption of its preference shares or debentures that have become due for redemption or payment of interest on such deposits or debentures or payment of dividend, or (e) company has not defaulted in payment of the dividend on preference shares or repayment of any term loan from a public financial institution or state level financial institution or scheduled bank that has become repayable or interest payable thereon or dues with respect to statutory payments relating to its employees to any authority or default in crediting the amount in investor education and protection fund. However, a company may issue equity shares with differential rights upon expiry of five years from the end of financial year in which such default was cured. Once issued, equity shares with differential voting rights cannot be converted into ordinary equity shares and similarly ordinary equity shares cannot be converted into equity shares with differential voting rights. However, the rights underlying an equity share with differential voting right can be varied in accordance with the provisions of Companies Act.

3. ***Issuance of Preference Shares:*** Section 55 of the Companies Act particularly sets out conditions for issuance of preference shares by a company. If permitted by the articles of association, a company may issue redeemable preference shares stipulating the date on which, or upon occurrence of an event at which, such preference shares would be redeemed. Redeemable preference shares can also be redeemed at the option of the company or the holder of the preference share. That said, the period of redemption cannot exceed 20 years from the date of issuance, with an exception for companies engaged in infrastructure projects. The modes of issuances for equity shares (along with the applicable attendant conditions) are applicable for preference shares as well. Particularly, in case of convertible preference shares, where convertible securities are offered under the private placement route, the price of the resultant shares is required to be determined beforehand based on a valuation report of a registered valuer.

4. ***Issuance of Debentures:*** A company may issue debentures (whether these are compulsorily convertible, optionally convertible or non-convertible) through private placement process (as detailed above). However, a company cannot issue debentures through other modes like rights issue or bonus issue. Section 71 of the Companies Act details out the conditions for issuance of debentures. Notably, while a company is required to comply with all conditions for issuance of non-convertible debentures, if the amount proposed to be raised by way of offer of non-convertible debentures is within the limits prescribed in Section 180(1)(c) of the Companies Act, the company would not require to obtain shareholders' approval from its shareholders (which is otherwise required as per the terms of Section 42 of the Companies Act).

**Creation of Debenture Redemption Reserve:** At the time of issuance of non-convertible debentures, a company is required to create debenture redemption

reserve which reserve is created out of the profits of the company available for payment of dividend. Debenture redemption reserve is required to be created only for non-convertible portion of the debentures. As such, debenture redemption reserve may not be required to be created for compulsorily convertible debentures or optionally convertible debentures. Since the requirement is that the amount to be credited as debenture redemption reserve should be carved out of profits of the company only, there is no obligation on the part of the company to create debenture redemption reserve if there is no profit for the particular year. The quantum of debenture redemption reserve to be created before the redemption liability actually arises in normal circumstances should be adequate to pay the value of debentures plus accrued interest (if not already paid), till the debentures are redeemed. As with the compulsorily convertible preference shares, where compulsorily convertible debentures are offered under the private placement route, the price of the resultant shares is required to be determined beforehand on the basis of a valuation report of a registered valuer.

### D. Return on Instruments

The holder of an instrument is liable to receive a return on its capital investment. Such return on investment varies from the kind of instrument issued by a company. The below section briefly discusses the kinds of return payable on relevant instruments.

1. ***Dividend on Equity Shares:*** Dividend is the return on the investment of shareholders in a company. A company may declare dividend for any financial year at a general meeting of the shareholders out of profits of the company for that year or any previous year or years arrived at after providing for depreciation or out of money provided by the Central Government or a State Government for the payment of dividend and no dividend shall be declared or paid by company from its reserves other than free reserves. The board of directors of a company may also declare interim dividend during any financial year or at any time during the period from closure of financial year till holding of the annual general meeting out of the surplus in the profit and loss account or out of profits of the financial year for which such interim dividend is sought to be declared or out of profits generated in the financial year till the quarter preceding the date of declaration of the interim dividend.

   Prior to declaration of dividend, a company shall transfer such percentage of its profits for that financial year as it may consider appropriate to the reserves of the company. Once declared, the dividend must be paid within a period of thirty days from the date of its declaration as per the Companies Act.

2. ***Dividend on Preference Shares:*** A company becomes liable to pay dividend on preference shares only when it declares dividend, and if in the meanwhile the preference shares are redeemed, the right of the preference shareholders to dividend, in the absence of any specific stipulation in this regard, does not continue after such redemption. Preference shares carry preferential right with respect to payment of dividend. Therefore, unless dividend has been declared on preference shares, the company cannot declare dividend on equity shares.

3. ***Interest on Debentures:*** A company is liable to pay interest on debentures in accordance with the agreed terms and not otherwise. The terms of debenture may also provide that if the principal amount is not paid back on the due date, the interest shall continue to be payable at the agreed rate. Just like the principal amount, interest on debentures is a debt payable by company and is payable whether there are or are no profits. Debentures usually provide that if default takes place in the payment of interest and continues up to a specified period, the principal shall become immediately payable.

**E. Transfer of Instruments**

Shares and debentures of a company are considered as movable property which are transferable in a manner provided in the articles of a company. While the statutory right of a shareholder to transfer shares has been provided under Sections 44 and 56 of the Companies Act, the manner of transfer shall be provided by the articles of association of a company. If a company has not adopted articles of association of its own, the regulations contained in model articles will apply. If the articles do not provide for the transfer of shares and the articles expressly exclude the application of the model articles, the general law relating to transfer of movable property will govern the transfer of shares.

While the Companies Act provides the principle to ensure free transferability of securities, companies can place reasonable restrictions on transferability under its articles of association. In case of private companies, it is necessary to place restrictions on transfer of securities to safeguard the basic nature of private companies. Accordingly, the transfer of securities of a private company is required to be approved by the board of directors of the company and whereas a transfer of securities of a public company is taken on record by the board of directors of public company.

For the purposes of transferring securities, it is an essential condition to register a transfer of securities through a duly stamped, dated and executed instrument with the company accompanied by the certificate relating to the securities. Such deed of transfer is required to be executed by both transferor and the transferee prior to submission to the company. Upon completion of the transfer, the transferee is recorded as the holder of the instrument in the applicable statutory register maintained by the company. In case of transfer of the instruments which are held in dematerialised form, the transfer is given effect by the depository by appropriately debiting and crediting the instrument in the demat account of the transferor and transferee respectively and accordingly such transfer is approved or recorded by the board of directors of a company.

**F. Extinguishment of Instrument**

Companies Act identifies different modes for extinguishment of an instrument, some of which are discussed briefly below:

1. ***Buy-Back of Shares***: A company is permitted to buy back its securities up to twenty five percent of its total paid up equity capital in a financial year subject to a cooling off period of three hundred and sixty-five days. Such buy-back can be given effect to only if approved by a special resolution

of the shareholders of the company, however, no approval of shareholders is required if the buy-back involves less than ten percent of the total paid up equity capital and free reserves of the company. While Companies Act permit buy back of fully paid-up equity shares and other specified securities, currently the Companies Act is silent on the scope of other specified securities for buy-back. A company can buy-back securities only out of the free reserves of the company, amount lying in the securities premium account or out of the proceeds of issue of any shares or other specified securities (but not using the proceeds of the same kind of shares or other specified securities which are being bought back).

2. ***Redemption of Preference Shares:*** The redeemable preference shares can be redeemed at a fixed time or on occurrence of a particular event or at the option of the shareholder or the company. Such preference shares can be redeemed out of profits or out of proceeds of a fresh issue of shares made for the purpose of redemption. Importantly, a company may only redeem preference shares which are fully paid up and the amount equal to redemption must be transferred to 'capital redemption reserve account' only in cases where redemption is proposed to take place out of profits of the company. The redemption of preference shares can be given effect only by payment of cash. Unless the terms of the issue of the shares provide for an option of conversion into equity shares, the preference shares have to be redeemed in cash.

3. ***Reduction of Share Capital:*** Another mechanism for extinguishment of an instrument could be reduction of share capital of the company. A company can reduce its share capital if such reduction is approved by the shareholders of the company and the National Company Law Tribunal. A company which is in arrears in repayment of any deposit or payment of interest thereon cannot reduce its share capital. The National Company Law Tribunal, while assessing the application for reduction of share capital, satisfies itself that the debt or claim of every creditor of the company has been discharged or determined or has been secured or consent of such creditor is obtained.

4. ***Redemption of Debentures:*** As with the redeemable preference shares, non-convertible debentures and optionally convertible debentures can be redeemed by a company in accordance with the terms of securities but subject to a maximum maturity period as discussed above. In addition to repayment of the principal amount, in case of redemption of debentures, the company is also required to pay interest on debentures redeemed in accordance with the terms of their issue. In case of default in redeeming the debentures on the date of maturity or paying the interest on such debentures when it is so due, an application may be made by debenture holder(s) or debenture trustee before the National Company Law Tribunal.

SS-IV-10

# Income-tax Implications for various Financial Instruments

CA Chirag Shah CA Rohan Umranikar

**Overview**

*Equity shares, preference shares, debentures, bonds, warrants/ options are some of the popular financial instruments. Hybrid or convertible instruments have also gained popularity due to the flexibility that such instruments provide. Along with commercial and regulatory considerations, income-tax implications also play a critical role while deciding the financial instrument to be opted for. The Issuer of the instrument as well as the Investor need to understand the post tax benefits/ returns that the instrument provides.*

*In this article, the authors discuss the income-tax implications for the complete life cycle of certain popular financial instruments. The authors also touch upon some of the debatable tax positions and conclude that the legislature or the tax administration could take proactive steps to provide more tax certainty to all stakeholders.*

## 1. Background

Capital is the life blood of any business. Businesses need to raise capital at every stage of their journey in order to fund various needs such as investment in capacities, working capital etc.

Conventional modes of raising capital are debt and equity. The choice between the two is driven by various factors such as expected return, duration, participation in management/ownership, expected cash flows of the business, growth stage of the business, safety of capital and so on. Hybrid instruments have also become quite popular with savvy investors and startups since they offer tailor made solutions for different business situations and investors with different risk appetites.

One of the most important factors that is considered by both, the business organisation as well as the investors, is the tax impact of any instrument throughout its life cycle.

In this article, we will be providing an overview of the key implications under the provisions of the Income-tax Act, 1961 ("ITA") over the life cycle of popular financial instruments, viz.:

a. Equity shares

b. Preference Shares

c. Debentures

d. Share warrants/options

SS-IV-11

## 2. Income-Tax Implications

### *2.1 Equity shares*

| S.N. | Event | Income-tax implications | |
|---|---|---|---|
| | | **In the hands of the Issuer** | **In the hands of the Investor** |
| 1 | Issue | • Under Section 56(2)(viib) of the ITA, if the shares of a company in which public are not substantially interested, are issued at a premium, the issue price as exceeding the fair market value ("FMV") of the shares shall be taxable under the head "Income from Other Sources".<br>• For a domestic company which opts for taxation as per Section 115BAA of the ITA, the tax rate would be 25.1682% (including surcharge and cess).<br>• This provision applies irrespective of whether the investor is a resident or a non-resident.<br>• FMV of the shares is to be computed as per the prescribed rules. | • Under Section 56(2)(x) of the ITA, if a person receives equity shares without consideration or for a consideration which is less than their FMV by an amount exceeding INR 50,000, then such FMV or the difference between FMV and the consideration shall be taxable under the head "Income from Other Sources".<br>• For a domestic company[1] which opts for taxation as per Section 115BAA of the ITA, the tax rate would be 25.1682% (including surcharge and cess). For a foreign company, the tax rate would be 40% (plus surcharge and cess).<br>• Treaty protection may be available to non-resident investors. E.g. Article 21 of the India-Germany tax treaty states that other income not dealt with in any of the treaty articles shall be taxable only in the country of residence.<br>• FMV of the shares is to be computed as per the prescribed rules. |

1. Section 2(22A) of the ITA defines "domestic company" as an Indian company, or any other company which, in respect of its income liable to tax under the ITA, has made the prescribed arrangements for the declaration and payment, within India, of the dividends (including dividends on preference shares) payable out of such income. Section 2(23A) of the ITA defines "foreign company" as a company which is not a domestic company.

| S.N. | Event | Income-tax implications | |
|---|---|---|---|
| | | **In the hands of the Issuer** | **In the hands of the Investor** |
| 2 | Dividend payouts | • No income-tax in the hands of the Issuer<br>• Issuer to withhold tax at the rate of 10% under Section 194 if dividends are paid to a resident investor in excess of INR 5,000 during the financial year and at the rate 20% (plus applicable surcharge and cess) under Section 195 read with Section 115A on dividends paid to non-resident investors. If the treaty prescribes a lower rate, the same would apply subject to the non-resident furnishing the prescribed documents/information[2].<br>• In case the Permanent Account Number is not furnished by the payee, the withholding tax rate would be 20% as per Section 206AA of the ITA. In case of a non-resident, if the Tax Residence Certificate (TRC), Tax Identification Number (TIN) and certain other details prescribed in Rule 37BC of the Rules are furnished, Section 206AA will not be applicable. It has been held in certain rulings that treaty provisions override Section 206AA[3]. | • Dividend shall be taxable under the head "Income from Other Sources" in the hands of the investor at the applicable tax rates.<br>• For a domestic company which opts for taxation as per Section 115BAA of the ITA, the tax rate would be 25.1682% (including surcharge and cess). For a foreign company, the tax rate would be 20% (plus surcharge and cess). If the treaty prescribes a lower rate, the same would apply subject to the non-resident furnishing the prescribed documents/ information.<br>• As per Section 80M, in the case of inter-corporate dividends, a deduction is allowed in the hands of the company receiving dividend to the extent that the same is further distributed as dividend within one month prior to the due date of filling the income-tax return. |

2. Tax Residence Certificate and Form 10F as per Section 90(4) and Section 90(5) of the ITA.
3. *Air India Ltd [TS-619-HC-2022(Del HC)]; Wipro Ltd [TS-1016-HC-2022(Kar HC)]; Danisco India Pvt. Ltd., vs. Union of India and Others (2018) 404 ITR 539 (Del HC)*

| S.N. | Event | Income-tax implications | |
|---|---|---|---|
| | | **In the hands of the Issuer** | **In the hands of the Investor** |
| 3 | Split-up and consolidation of shares | • No tax implications | • Stock split and consolidation may not be regarded as a transfer as per Section 2(47) of the ITA and hence, should not have any tax implications.<br>• The cost of acquisition of such consolidated/sub-divided shares shall be computed with reference to the cost of acquisition of the original shares on a proportionate basis, in accordance with Section 55(2)(b)(v) of the ITA.<br>• Holding period of the shares dates back to the acquisition of the original shares. |
| 4 | Sale/transfer | No tax implications | **Direct transfer of listed equity shares:**<br>For resident as well as non-resident investors:<br>• If the shares are held for a period upto 12 months, the gains arising on transfer of the shares shall be taxable as short-term capital gains ("STCG"). STCG from sale of shares on the stock exchange are taxable at the rate of 15% (plus applicable surcharge and cess), in accordance with Section 111A of the ITA.<br>• STCG from the sale of other listed shares are taxed as per the ordinary tax rates.<br>• If the shares are held for a period exceeding 12 months, the gains on transfer of such shares shall be taxable as long-term capital gains ("LTCG"). |

| S.N. | Event | Income-tax implications | |
|---|---|---|---|
| | | In the hands of the Issuer | In the hands of the Investor |
| | | | LTCG, derived from sale of shares on the stock exchange, exceeding INR 1 lakh, shall be taxed at the rate of 10% (plus surcharge and cess), in accordance with Section 112A of the ITA.<br>• LTCG from the sale of listed shares off the stock market will be taxable at 20% (plus applicable surcharge and cess) in accordance with Section 112 of the ITA. Indexation benefit shall be available to a resident while computing the LTCG. Alternatively, the taxpayer (resident/non-resident) may choose to pay tax at the rate of 10% (plus applicable surcharge and cess) without claiming indexation benefit.<br>• Treaty protection may be available to non-resident shareholders in certain cases.<br>**Direct transfer of unlisted equity shares/Direct Indirect transfer by a non-resident of listed or unlisted equity shares:**<br>For resident investors:<br>• If shares are held for a period upto 24 months, the gains arising on transfer of the shares shall be taxable as STCG at the applicable tax rates. The tax rate is 25.1682% (including surcharge and cess) in case of a domestic company which has opted for taxation as per Section 115BAA of the ITA. For a foreign company, |

| S.N. | Event | Income-tax implications | |
|---|---|---|---|
| | | In the hands of the Issuer | In the hands of the Investor |
| | | | the tax rate would be 40% (plus surcharge and cess).<br>• If the shares are held for a period exceeding 24 months, the gains on transfer of such shares shall be taxable as LTCG, at the rate of 20% (plus surcharge and cess), in accordance with Section 112 of the ITA. Indexation benefit shall be available while computing the long-term capital gains.<br>• If the FMV of the shares transferred exceeds the actual sale consideration, the FMV will be deemed to be the sale consideration, as per Section 50CA of the ITA. Transfer pricing provisions may get attracted if the transfer is to a non-resident Associated Enterprise (AE).<br><u>For non-resident investors:</u><br>• If shares are held for period upto 24 months, the gains arising on transfer of the shares shall be taxable as STCG at the applicable tax rates. The tax rate is 40% (plus surcharge and cess) in case of a foreign company.<br>• If the shares are held for a period exceeding 24 months, the gains on transfer of such shares shall be taxable as LTCG at the rate of 10% (plus surcharge and cess), in accordance with Section 112 of the ITA. Indexation and |

| S.N. | Event | Income-tax implications | |
|---|---|---|---|
| | | **In the hands of the Issuer** | **In the hands of the Investor** |
| | | | foreign exchange fluctuation benefit shall not be available while computing the long-term capital gains.<br>• Treaty protection may be available to non-resident shareholders in certain cases.<br>• In case of sale of shares of a foreign company, which directly or indirectly derive atleast 50% from assets located in India on the specified date, these shares shall be deemed to be situated in India and proportionate gains on transfer thereof will be taxable in India (indirect transfers) subject to treaty protection, if any.<br>• If the FMV of the shares transferred exceeds the actual sale consideration, the FMV will be deemed to be the sale consideration, as per Section 50CA of the ITA. Transfer pricing provisions may get attracted if the transfer is to a resident/non-resident Associated Enterprise (AE). |
| 5 | Buy-back | Tax at the rate of 23.296% on the "distributed income", in accordance with Section 115QA of the ITA. "Distributed income" means the consideration paid by the company on buyback of shares as reduced by the amount which was received by the company for issuance of such shares. The amount received by the company is to be determined in accordance with Rule 40BB which covers different scenarios. | No tax in the hands of the shareholder, in accordance with Section 10(34A) of the ITA. |

SS-IV-17

| S.N. | Event | Income-tax implications | |
|---|---|---|---|
| | | **In the hands of the Issuer** | **In the hands of the Investor** |
| 6 | Capital reduction | No tax implications | To the extent the consideration on capital reduction relates to accumulated profits of the company, it will be taxable as dividend (taxable as per point 2 above). The balance consideration will be deemed to be the sale consideration for the purpose of computing capital gains. Capital gains will be taxable as per point 4 above. |

**Points to ponder:**

- ***Issue of shares and applicability of Section 56(2)(x)***

Section 56(2)(x) states that where any person "receives" a property at a value which is less than its FMV and difference between the same is in excess of INR 50,000, the excess of FMV over actual consideration paid shall be taxable as income from other source in the hands of the recipient. Property includes, inter alia, shares and securities.

In a recent ruling[4] in the context of Section 56(2)(vii) (having similar wordings as Section 56(2)(x)), the Gujarat High Court ("HC") has held that property should be "received from any other person" and for receipt of property, there must be pre-existence of property which one can transfer. Fresh issue/allotment of shares would result in creation of shares and hence, S.56(2)(vii) would not apply.

In view of this, it is arguable that provisions of Section 56(2)(x) may not be triggered in case of any fresh issue of shares (rights issue/ preferential issue etc). Interestingly, the Central Board of Direct Taxes (CBDT)[5] had issued a Circular[6] stating that Section 56(2)(x) does not apply in case of a fresh issue of shares which was subsequently withdrawn[7].

It may also be noted that the Mumbai bench of the Income Tax Appellate Tribunal (ITAT) has held[8] that a disproportionate rights issue at a price which is less than FMV could lead to taxation under Section 56(2)(x) of the ITA in the hands of the recipient shareholder. In view of this, litigation cannot be ruled out if there is a disproportionate issue of shares at a price which is less than FMV.

In the context of bonus issue, the position is clearer. The Karnataka HC has held[9] that issue of bonus shares through capitalisation

4. *PCIT vs. Jigar Jashwantlal Shah [2023] 154 taxmann.com 568 (Gujarat)*
5. Apex body for tax administration in India
6. Circular No 10/2018 dated 31 December 2018
7. Circular No 2/2019 dated 4 January 2019
8. *Sudhir Menon (HUF) vs. ACIT (2014) 162 TTJ 0425 (Mum ITAT)*
9. *PCIT vs. Dr Ranjan Pai [2021] 124 taxmann.com 241 (Kar HC)*

of reserves is merely a reallocation of issuer company's funds and there is no fresh inflow of any funds or increase in the capital employed. When there is an issue of bonus shares, the money remains with the company, and nothing comes to the shareholders as there is no transfer of the property and therefore, fair value of bonus shares cannot be brought to tax.

- **Buyback of shares at less than FMV**

The Mumbai ITAT has held[10] that buyback of shares at a price which is less than FMV does not trigger Section 56(2)(x) as buyback leads to extinguishment of shares and does not tantamount to the company receiving "property".

- **Sale of shares of an Indian company by a non-resident/foreign company – Computation**

In the case of a non-resident/foreign company, Section 112(1)(c)(iii) provides for a concessional tax rate of 10%; however, it prohibits foreign exchange fluctuation and indexation benefits. It is arguable that if a transaction results in a loss by applying the computation provisions specified under Section 48 of the ITA (e.g. on account of foreign exchange fluctuation benefit), there is no reason to apply the tax rate specified under Section 112(1)(c)(iii) and hence, the net result would be a capital loss. However, in a recent ruling, the Mumbai ITAT[11] has held that Section 112(1)(c)(iii) is a more specific provision whereas Section 48 is a general provision dealing with computation of income under the head "Capital Gains" and hence, when Section 112(1)(c)(iii) specifically states that effect of indexation and foreign exchange fluctuation as per the provisos to Section 48 is not to be considered for computing the capital gains, the same shall not be available to the taxpayers. With due respect to the ITAT, the conclusion is debatable and the controversy may be resolved at higher appellate forums.

### 2.2 Preference shares

Following types of preference shares are generally issued by companies:

a. Redeemable Preference Shares ('RPS') – these are redeemable for cash after a specific period.

b. Compulsorily Convertible Preference Shares ('CCPS') – these are compulsorily converted into equity shares after a specific period.

c. Optionally Convertible Preference Shares ('OCPS') – these are convertible into equity shares or redeemable for cash at the option of the investor or the issuer.

We have discussed the key income-tax implications for these preference shares in the following table:

10. *Vora Financial Services Pvt Ltd vs. ACIT [(2018) 96 taxmann.com 88 (Mum.)]*

11. *Legatum Ventures Ltd., vs. ACIT [(2023) 149 taxmann.com 436 (Mum)].*

| S.N. | Event | Income-tax implications | |
|---|---|---|---|
| | | **In the hands of the Issuer** | **In the hands of the Investor** |
| 1 | Issue | Same as equity shares. The valuation methodology, however, is different. | Same as equity shares. The valuation methodology, however, is different. |
| 2 | Dividend payouts | No tax implications | Same as equity shares. |
| 3 | Sale/transfer/ redemption | No tax implications | **Listed preference shares:**<br>For resident as well as non-resident investors:<br>• If held for a period upto 12 months, the gains arising on transfer of the shares shall be taxable as STCG at the applicable tax rates. The tax rate for a foreign company is 40% (plus applicable surcharge and cess).<br>• If the shares have been held for a period exceeding 12 months, the gains on transfer of such shares shall be taxable as LTCG at 20% (plus applicable surcharge and cess), in accordance with Section 112 of the ITA. Indexation benefit shall be available to a resident while computing the LTCG. Alternatively, the taxpayer (resident/non-resident) may choose to pay tax at the rate of 10% (plus applicable surcharge and cess) without claiming indexation benefit.<br>• Treaty protection may be available to non-resident shareholders in certain cases.<br>• Transfer pricing provisions may get attracted if the transfer is to an Associated Enterprise (AE). |

SS-IV-20

<table>
<tr><th rowspan="2">S.N.</th><th rowspan="2">Event</th><th colspan="2">Income-tax implications</th></tr>
<tr><th>In the hands of the Issuer</th><th>In the hands of the Investor</th></tr>
<tr><td></td><td></td><td></td><td>Unlisted preference shares:<br>• Same as unlisted equity shares.</td></tr>
<tr><td>4</td><td>Buyback</td><td colspan="2">Same as the treatment in case of equity shares.</td></tr>
<tr><td>5</td><td>Capital reduction</td><td colspan="2">Same as the treatment in case of equity shares.</td></tr>
<tr><td>6</td><td>Conversion into equity shares (applicable in case of CCPS/ OCPS)</td><td>In case the conversion ratio is decided at the time of issue of the preference shares and if the same is on the basis of the FMV of the underlying equity shares, it is arguable that the Issuer will not be taxable under Section 56(2)(viib) upon conversion.</td><td>• Conversion is not treated as a transfer in view of Section 47(xb) and hence, does not trigger capital gains tax.<br>• Cost of acquisition shall be determined based on the cost of acquisition of the preference shares that have been converted [Section 49(2AE].<br>• Holding period will be counted from the date of acquisition of the preference shares [Section 2(42A)(hf)]<br>• In case the conversion ratio is decided at the time of issue of the preference shares and if the same is on the basis of the FMV of the underlying equity shares, it is arguable that the Investor will not be taxable under Section 56(2)(x) upon conversion. However, this is debatable and the tax authorities could seek to consider the FMV of the equity shares on the date of receipt of the shares and tax the difference, if any.</td></tr>
</table>

**Points to ponder:**

- **Whether redemption of preference shares can be regarded as capital reduction/purchase of shares by the company resulting in dividend taxation under Section 2(22)(d) or buyback taxation under Section 115QA:**

SS-IV-21

Given the difference in the process of redemption of preference shares and reduction of capital under the Companies Act 2013, it can be argued that redemption of preference shares cannot be regarded as reduction of capital. Hence, it should not trigger tax implications under Section 2(22)(d). Further, if the preference shares are issued for full cash consideration and are not participating in nature, Section 2(22)(d) should not apply.

As regards buy-back taxation under Section 115QA, relying on a Supreme Court ruling[12], it could be argued that redemption of preference shares is akin to purchase of shares by the issuing company and consequently covered under Section 115QA of the ITA. On the other hand, it could also be argued that redemption of preference shares is nothing but discharge of a contractual obligation by the company and not a purchase of shares. The issue is vexed and clarity will emerge after judicial pronouncements on this issue. An advance ruling could be considered in eligible cases to avoid long drawn litigation.

### *2.3 Debentures/bonds*

Following types of debt instruments are generally issued by companies:

a. Non-Convertible Debentures ('NCD') - these are redeemable for cash after a specific period.

b. Compulsorily Convertible Debentures ('CCD') - these are compulsorily converted into equity shares after a specific period.

c. Optionally Convertible Debentures ('OCD') - these are convertible into equity shares or redeemable for cash at the option of the investor or the issuer.

d. Bonds

We have discussed the key income-tax implications for these debt instruments in the following table:

| S.N. | Event | Income-tax implications | |
|---|---|---|---|
| | | **In the hands of the Issuer** | **In the hands of the Investor** |
| 1 | Issue | No tax implications | Under Section 56(2)(x) of the ITA, if a person receives any security without consideration or for a consideration which is less than the fair market value of the securities by an amount exceeding Rs. 50,000, then such fair market value or the difference between fair market value and the consideration shall be taxable under the head "Income from Other Sources". |

12. *Anarkali Sarabhai vs CIT 90 Taxman 509 (SC).*

| S.N. | Event | Income-tax implications | |
|---|---|---|---|
| | | **In the hands of the Issuer** | **In the hands of the Investor** |
| | | | Debentures could be considered as a "security" and hence, if the debentures are issued at a price which is less than their FMV, it could trigger taxation in the hands of the Investor.<br><br>Treaty protection may be available to a non-resident Investor. |
| 2 | Interest | Interest shall be a deductible expense, subject to the thin capitalisation provisions as per Section 94B of the ITA, transfer pricing (if applicable) and deduction of applicable tax at source.<br><br>In case the Permanent Account Number is not furnished by the payee, the withholding tax rate would be 20% as per Section 206AA of the ITA. In case of a non-resident, if the Tax Residence Certificate (TRC), Tax Identification Number (TIN) and certain other details prescribed in Rule 37BC of the Rules are furnished, Section 206AA will not be applicable. Section 206AA is also not applicable in case of payment of interest on long-term bonds referred to in S.194LC. It has been held in certain rulings that treaty provisions override Section 206AA[13]. | Interest shall be taxable under the head "Income from Other Sources" in the hands of the investor at the applicable tax rates. In case of a non-resident lender, following could be the applicable tax rates:<br><br>• 20% on a gross basis in case the debt incurred is in foreign currency [Section 115A].<br><br>• 5% on a gross basis under Section 194LC[14].<br><br>• 40% on a net basis in other cases.<br><br>• Rate as prescribed under the tax treaty, if the same is more beneficial |

13. *Air India Ltd [TS-619-HC-2022(Del HC)]; Wipro Ltd [TS-1016-HC-2022(Kar HC)]; Danisco India Pvt. Ltd., vs. Union of India and Others (2018) 404 ITR 539 (Del HC).*
14. This covers, inter-alia, interest on (a) any foreign currency loan borrowed before 1 July 2023 (b) any long term foreign currency bond issued before 1 July 2023 (c) Rupee Denominated Bond issued before 1 July 2023 (d) long-term bond or RDB issued after 1 July 2023 which is listed on a recognised stock exchange located in an International Financial Services Centre

| S.N. | Event | Income-tax implications | |
|---|---|---|---|
| | | **In the hands of the Issuer** | **In the hands of the Investor** |
| 4 | Sale/transfer/ redemption | • No tax implications in case of sale/transfer of debentures.<br>• If redemption happens at lower than FMV, Section 56(2)(x) could be triggered on the basis that the company received a benefit by extinguishing its liability for a lower amount. | **Listed debentures:**<br>For resident as well as non-resident investors:<br>• If held for a period upto 12 months, the gains arising on transfer shall be taxable as STCG at the applicable tax rates. If held for a period exceeding 12 months, the gains on transfer shall be taxable as LTCG at 10% (plus applicable surcharge and cess), in accordance with Section 112 of the ITA. Indexation benefit is not available while computing LTCG in case of debentures.<br>• Transfer pricing provisions may get attracted if the transfer is to an Associated Enterprise (AE).<br>• For non-resident investors, treaty protection may be available in most cases. |
| | | | **Unlisted debentures:**<br>For resident as well as non-resident investors:<br>• If held for a period upto 36 months, the gains arising on transfer shall be taxable as STCG at the applicable tax rates. If held for a period exceeding 36 months, the gains on transfer shall be taxable as LTCG at 20% in case of residents and 10%[15] in case of |

15. In order to avail the 10% tax rate, the debenture will need to qualify as a "security" as per Section 2(h) of the Securities Contracts (Regulation) Act, 1956

| S.N. | Event | Income-tax implications | |
|---|---|---|---|
| | | **In the hands of the Issuer** | **In the hands of the Investor** |
| | | | non-residents (plus applicable surcharge and cess), in accordance with Section 112 of the ITA. Indexation benefit is not available while computing LTCG in case of debentures.<br>• Transfer pricing provisions may get attracted if the transfer is to an Associated Enterprise (AE).<br>• For non-resident investors, treaty protection may be available in most cases. |
| 5 | Conversion into equity shares (applicable in case of CCDs/ OCDs) | In case the conversion ratio is decided at the time of issue of the debenture and if the same is on the basis of the FMV of the underlying shares, it is arguable that the Issuer will not be taxable under Section 56(2)(viib) upon conversion of debentures. | • Conversion is not treated as a transfer in view of Section 47(x) and hence, does not trigger capital gains tax.<br>• Cost of acquisition shall be determined based on the cost of acquisition of the debentures that have been converted [Section 49(2A).<br>• Holding period will be counted from the date of acquisition of the debenture [Explanation (ii) to S.2(42A) read with Rule 8AA(2)].<br>• In case the conversion ratio is decided at the time of issue of the debenture and if the same is on the basis of the FMV of the underlying shares, it is arguable that the Investor will not be taxable under Section 56(2)(viib) upon conversion of debentures. However, this is debatable and the tax authorities could seek to |

| S.N. | Event | Income-tax implications | |
|---|---|---|---|
| | | **In the hands of the Issuer** | **In the hands of the Investor** |
| | | | consider the FMV of the shares on the date of receipt of the shares and tax the difference, if any. |

**Points to ponder:**

- **Deductibility of interest on CCDs:**

Tax authorities could take a stand that interest on CCDs is akin to dividend and therefore, is not a deductible expense. In this regard, there have been numerous HC and ITAT rulings[16] which have held that debenture, whether or not convertible into equity, is a debt. CCDs continue to be debt instruments till conversion into shares and interest paid thereon is a deductible expenditure under Section 36(1)(iii) of the ITA. It would be important to review the terms of the CCDs to determine the deductibility of interest.

- **Deductibility of premium on redemption:**

Tax authorities could take a stand that premium on redemption of debentures is a capital expenditure and hence, is not deductible. However, there are numerous HC and ITAT rulings to the effect that premium on redemption of debentures is a revenue expenditure and may be spread proportionately over the term of the debentures[17].

### 2.4 Share warrants/options

Where a company and a potential investor desire certain commercial flexibilities, share warrants/options could be issued by the company to the investor. The conversion ratio, tenure and payment timelines of the warrants/options could be agreed upfront between the investor and the company.

Following are the key income-tax implications for such warrants/options:

| S.N. | Event | Income-tax implications | |
|---|---|---|---|
| | | **In the hands of the Issuer** | **In the hands of the Investor** |
| 1 | Issue | • No tax implications for the Issuer of share warrants. | • In case of warrants/options in a private company, it could |

16. *CIT vs. Secure Meters Ltd. [2008] 175 Taxman 567 (Rajasthan), Religare Finvest Ltd vs. DCIT (I.T.A. Nos. 4796/DEL/2017, 5202/DEL/2017, 547/DEL/2018, 1105/DEL/2018, 7856/DEL/2017, 133/DEL/2018, 6116/DEL/2018 and 7553/DEL/2018)*
17. *Nitesh Housing Developers (P.) Ltd., vs. DCIT [2022] 145 taxmann.com 30 (Karnataka), DCIT vs. Gujarat Narmada Valley Fertilizers Co. Ltd. [2013] 33 taxmann.com 265 (Gujarat), ACIT vs. Cleta Real Estate (P.) Ltd. [2022] 145 taxmann.com 76 (Delhi - Trib.)*

| S.N. | Event | Income-tax implications | |
|---|---|---|---|
| | | **In the hands of the Issuer** | **In the hands of the Investor** |
| | | • Option premium, if any, would be taxable in the hands of the option writer at ordinary rates. | be argued that the same do not qualify as "security" and hence, Section 56(2)(x) should not apply.<br>• In case of warrants/options in a public company, Section 56(2)(x) implications could arise if the warrants/options are priced below their FMV.<br>• Non-residents may have treaty protection. |
| 2 | Sale/transfer | No tax implications | <u>For resident as well as non-resident investors:</u><br>• If held for a period upto 36 months, the gains arising on transfer shall be taxable as STCG at the applicable tax rates. If held for a period exceeding 36 months, the gains on transfer shall be taxable as LTCG at 20% with indexation benefit in case of residents and 10%[18] in case of non-residents (plus applicable surcharge and cess), in accordance with Section 112 of the ITA.<br>• Section 50CA should not apply since it applies only to unquoted "shares".<br>• Transfer pricing provisions may get attracted if the transfer is to an Associated Enterprise (AE). |

18. In order to avail the 10% tax rate, the debenture will need to qualify as a "security" as per Section 2(h) of the Securities Contracts (Regulation) Act, 1956

| S.N. | Event | Income-tax implications | |
|---|---|---|---|
| | | **In the hands of the Issuer** | **In the hands of the Investor** |
| | | | • For non-resident investors, treaty protection may be available in most cases. |
| 3 | Exercise | In case the conversion ratio is decided at the time of issue of the warrants/options and if the same is on the basis of the FMV of the underlying shares, it is arguable that the Issuer will not be taxable under Section 56(2)(viib) upon conversion | • In case the conversion ratio is decided at the time of issue of the warrants/options and if the same is on the basis of the FMV of the underlying shares, it is arguable that the Investor will not be taxable under Section 56(2)(x) upon 6 conversion.<br>• However, this is debatable and the tax authorities could seek to consider the FMV of the shares on the date of receipt of the shares and tax the difference, if any. |

### 3. Concluding Thoughts

Commercial aspects of the deal as well as tax implications play a crucial role in selection of the appropriate instrument to be used for funding. There are several practical situations where there could be complexities in the tax treatment and it is advisable for taxpayers to tread with caution in such situations. Advance rulings could be sought wherever necessary. Also, it would be ideal if the legislature/CBDT brings in proactive amendments/clarifications to provide tax certainty to Investors and Issuers.

"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*

SS-IV-28

# Decoding Financial Instruments: FEMA perspective

CA Vishal Gada CA Zeel Jambuwala

**Overview**

*The Foreign Exchange Management Act, 1999 (FEMA) is a key regulatory framework in India that governs foreign exchange transactions which also include transactions related to the financial instruments. Generally, financial instruments cover a broad spectrum of assets and securities such as equity shares, convertible instruments like CCD / CCPS, non-convertible instruments like NCD etc. While the selection of securities is influenced by the commercial understanding between the parties to the transaction, a comprehensive understanding and adherence to relevant FEMA regulations is paramount for investors engaging in transactions involving these financial instruments.*

*With this backdrop, the authors have discussed the key FEMA regulations pertaining to investment and transfer of different types of securities issued by a company incorporated in India by a person resident outside India. The authors have also briefly touched upon some of the important concepts under FEMA related to investment and transfer of securities of an overseas company by a person resident in India.*

**Overview**

The Foreign Exchange Management Act, 1999 (FEMA) is a key regulatory framework in India that governs foreign exchange transactions which also include transactions related to the financial instruments. Generally, financial instruments cover a broad spectrum of assets and securities such as equity shares, convertible instruments like CCD/CCPS, non-convertible instruments like NCD etc. While the selection of securities is influenced by the commercial understanding between the parties to the transaction, a comprehensive understanding and adherence to relevant FEMA regulations is paramount for investors engaging in transactions involving these financial instruments.

With this backdrop, the authors have discussed the key FEMA regulations pertaining to investment and transfer of different types of securities issued by a company incorporated in India by a person resident outside India. The authors have also briefly touched upon some of the important concepts under FEMA related to investment and transfer of securities of an overseas company by a person resident in India.

## Introduction

As we all know, India has exchange control regulations codified under the FEMA which regulates the cross-border transactions based on their classification in terms of Capital Account transactions and Current Account transactions. Investments by non-residents in the securities of a company incorporated in India and investments by Indian residents in the securities of an overseas company are typically regarded as Capital Account transactions which require conformity with the provisions of FEMA as well as various rules and regulations framed thereunder. In general, investment cycle associated with a security can be bifurcated into three phases:

- Phase I: Making investment or acquisition
- Phase II: Holding of investment
- Phase III: Transfer of investment or Divestment

The FEMA provisions typically apply at the time of making investment/acquisition or at the time of divestment. Holding of investment would generally result in income in the form of interest or dividend depending on the nature of security. While such income may not have any significant implications under FEMA, the same may have tax implications including transfer pricing. Since the current chapter focuses on FEMA provisions, the tax implications arising on account of income in the form of interest or dividend have not been dealt with in this chapter.

For ease of reading, we have divided this chapter into two parts. Part A deals with investment by a person resident outside India in an Indian company (popularly known as Inbound Investment) whereas Part B deals with investment by a person resident in India in a foreign entity (popularly known as Outbound Investment).

## A. Foreign Investment in India ('Inbound Investment')

In the past several years, India has seen an influx of foreign investment in various sectors and across various industries. Investments in, and acquisition of securities of, Indian companies by non-resident entities and individuals, are governed by the terms of the Foreign Exchange Management (Non-Debt Instruments) Rules, 2019 ('NDI Rules'), and the provisions of the Consolidated Foreign Direct Investment Policy Circular ('FDI Policy') issued by the Department for Promotion of Industry and Internal Trade ("DPIIT").

So far as the entry routes for making investment in India are concerned, there are broadly three entry routes available for foreign investment in India: (a) Foreign Direct Investment ('FDI') (b) Foreign Portfolio Investor ('FPI'); (c) Foreign Venture Capital Investor ('FVCI'). Given the choice of entry routes available to foreign investors while making investment in India, the regulations that need to be analysed from FEMA perspective would entirely depend on the entry route of the non-resident investor. Therefore, for ease of understanding of the readers, this chapter contains analysis of the relevant rules/ regulations of FEMA applicable for various financial instruments qua the entry route of the non-resident investor.

## 1. FDI

FDI (Foreign Direct Investment) means investment through equity instruments by a person resident outside India –

i. in an unlisted Indian company; or

ii. in 10% or more of the post issue paid-up equity capital on a fully diluted basis of a listed Indian company.

'Equity Instruments' are defined to mean equity shares, compulsory convertible

debentures, compulsory convertible preference shares and share warrants issued by an Indian company. Let us now analyse the rules and regulations related to these instruments in detail.

### *1.1 Investment in various types of Equity Instruments under the FDI Route:*

***Types of Instruments:***

**1.1.1 Equity Shares:** This will include Equity Shares issued by an Indian company in accordance with the provisions of the Companies Act, 2013 and will also include equity shares that are partly paid. In case of partly paid shares, 25% of the total consideration amount (including share premium, if any) has to be received upfront and the balance consideration should be received within a period of 12 months from the date of issue of partly paid shares.

**1.1.2 Preference Shares:** Preference Shares are subject to the conditions related to FDI such as Sectoral Caps etc. only if they are compulsorily convertible preference shares. Therefore, if the Preference Shares are Compulsorily Convertible Preference Shares (‘CCPS’), issued by an Indian company to a person resident outside India, it would be subject to the provisions of NDI Rules. Preference Shares which are not compulsorily convertible into equity shares such as Optionally Convertible Preference Shares (‘OCPS’) or Redeemable Preference Shares (‘RPS’) are treated as debt instruments. Therefore, issue of OCPS/RPS would not be governed by the provisions of NDI Rules. It would be treated as External Commercial Borrowing (‘ECB’).[It may be mentioned that companies act does not permit non redeemable preference shares!]

**1.1.3 Debentures:** Issue of debentures by an Indian company to a person resident outside India would be subject to the provisions of NDI Rules only if they are Compulsorily Convertible Debentures (‘CCD’). Debentures which are not compulsorily convertible into Equity Shares such as Optionally Convertible Debentures (‘OCD’) or Non-Convertible Debentures (‘NCD’) are treated as debt instruments. Therefore, issue of OCD/NCD would not be governed by the provisions of NDI Rules. Issue of OCD/NCD by an Indian company to a person resident outside India should conform to ECB guidelines. However, investment by a Securities and Exchange Board of India (‘SEBI’) registered Foreign Portfolio Investor (FPI) in NCDs issued by an Indian company would not be regarded as ECB (see our comments below under FPI section).

**1.1.4 Warrants:**

The NDI Rules state that the issue of ‘Share Warrants’ must be in accordance with the regulations made by SEBI, the Companies Act, 2013 or any other applicable law. In case of Share Warrants, at least 25% of the consideration should be received upfront and the balance amount should be received within 18 months of the issuance of Share Warrants.

**1.1.5** All equity instruments can contain an optionality clause subject to a minimum lock-in period of one year or as prescribed for the specific sector, whichever is higher, but without any

option or right to exit at an assured price.

**1.1.6 Convertible Notes:**

These can be issued only by Start-up Companies which are recognized as such by the DPIIT. It is important to note that Convertible Note is not specifically covered in the definition of 'Equity Instruments' provided under the NDI Rules. The issue of Convertible Notes by an Indian Start-up Company to a Person Resident Outside India ('PROI') is dealt with separately under the NDI Rules. Convertible Note is defined to mean an instrument issued by a Startup company acknowledging receipt of money initially as debt, repayable at the option of the holder, or which is convertible into such number of equity shares of that company, within a period not exceeding 10 years from the date of issue of the convertible note, upon occurrence of specified events as per other terms and conditions agreed and indicated in the instrument.

The non-resident investors may purchase convertible notes for an amount of INR 25 lakh or more in a single tranche. If the start-up company is engaged in a sector where investment by a person resident outside India requires Government approval, then Convertible Notes can be issued only with prior approval. Further, issue of equity shares against such Convertible Notes is subject to compliance with entry route, sectoral caps, pricing guidelines, etc.

***1.2 Transfer or Divestment of Equity Instruments of an Indian Company:***

Following table summarizes the key provisions related to transfer of equity instruments by or to a PROI:

| Seller | Buyer | Automatic Route | Remarks |
|---|---|---|---|
| PROI other than Non-resident Indian ('NRI')/Overseas Citizen of India ('OCI') | Any other PROI including NRI/OCI | Transfer through Sale/ Gift – No Pricing Guidelines | If FPI buys ≥ 10% – The excess shares over the threshold of 10% to be divested within 5 trading days |
| NRI/OCI – Repatriable basis | Any other PROI including NRI/OCI | Transfer through Sale/ Gift – No Pricing Guidelines | If NRI/OCI buys > 5% in a listed Indian Co. – The excess shares over the threshold of 5% to be divested within 5 trading days |
| Person Resident in India ('PRII') or NRI/ OCI holding Equity Instruments on Non-repatriation basis | Any PROI including NRI/OCI | Transfer through Sale – Pricing Guidelines applicable | Pricing Guidelines not applicable if buyer is an NRI/OCI buying on Non-repatriable basis |

SS-IV-32

| Seller | Buyer | Automatic Route | Remarks |
|---|---|---|---|
| PRII or NRI/OCI holding Equity Instruments on Non-repatriation basis | Any PROI including NRI/OCI who is a relative of the donor (Relative as per the Companies Act) | Transfer through Gift – Need prior approval of RBI | Gift cannot exceed 5% of paid-up capital of the Indian company.<br>Value of Security should not exceed $50,000 during the Financial Year |
| PROI | PRII | Transfer through Sale/Gift – For sale – Pricing Guidelines applicable<br>Must not be more than the Fair Market Value | Pricing Guidelines not applicable if PROI is holding equity instruments on Non-repatriable basis |
| PRII | PROI | Transfer through Sale – Pricing Guidelines applicable | - |

*1.3 Pricing Guidelines:*

**1.3.1 For Equity Instruments issued by the Indian company to a person resident outside India:**

The price of equity instruments of an Indian company issued by it to a person resident outside India should not be less than:

(a) In case of a listed company: The price worked out in accordance with the relevant SEBI guidelines in case of a listed Indian company or in case of a company going through a delisting process as per the SEBI (Delisting of Equity Shares) Regulations, as amended from time to time; or

(b) In case of an unlisted company: The valuation of equity instruments done as per any internationally accepted pricing methodology for valuation on an arm's length basis duly certified by a Chartered Accountant or a SEBI registered Merchant Banker or a practicing Cost Accountant. It may be noted that the phrase internationally accepted pricing methodology is not defined in the NDI Rules. However, 'internationally accepted pricing methodology' would typically mean any valuation methodology which has international recognition, e.g., Discounted Cash Flow, Net Asset Value, Comparable Company Method, etc.

**1.3.2 Swap of Equity Instruments:**

In case of Swap of Equity Instruments, irrespective of the amount, valuation will have to be made by a Merchant Banker registered with SEBI or

an investment banker outside India registered with appropriate regulatory authority in host country.

**1.3.3 Subscription to Memorandum of Association ('MOA'):**

Where shares in an Indian Co. are issued to PROI in compliance with the provisions of the Companies Act, 2013, by way of subscription to Memorandum of Association, such investments can be made at face value subject to entry route and sectoral caps.[Is there a mandate to issue it at Fave Value?]

**1.3.4 For Equity Instruments transferred by a PRII to a PROI:**

The price of equity instruments of an Indian company transferred by a PRII to a PROI should not be less than:

(a) In case of a Listed Indian company: The price worked out in accordance with the relevant SEBI guidelines or the price at which a preferential allotment of shares can be made under the SEBI Guidelines, as applicable; or

(b) In case of an Unlisted Indian company: The valuation of equity instruments done as per any internationally accepted pricing methodology for valuation on an arm's length basis duly certified by a Chartered Accountant or a SEBI registered Merchant Banker or a practicing Cost Accountant.

**1.3.5 For Equity Instruments transferred by a PROI to a PRII:**

The price of equity instruments of an Indian Company transferred by a PROI to a PRII should not exceed:

(a) In case of a Listed Indian company: The price worked out in accordance with the relevant SEBI guidelines or the price at which a preferential allotment of shares can be made under the SEBI guidelines, as applicable; or

(b) In case of an Unlisted company: The valuation of equity instruments done as per any internationally accepted pricing methodology for valuation on an arm's length basis duly certified by a Chartered Accountant or a SEBI registered Merchant Banker or a practicing Cost Accountant.

The guiding principle would be that PROI is not guaranteed any assured exit price at the time of making such investment/agreement and shall exit at the price prevailing at the time of exit.

**1.3.6 Partly Paid Shares:**

The pricing of the partly paid equity shares should be determined upfront.

**1.3.7 Issue of right shares:**

The price of shares offered on right basis by the Indian company to non-resident shareholders shall be:

- In case of a listed Indian company, the rights issue shall be at a price determined by the company;
- In case of an unlisted Indian company, the rights issue shall not be at a price less than the price offered to persons resident in India.

**1.3.8 Convertible Equity Instruments:**

In case of convertible equity instruments, the price/conversion formula of the instrument is required

to be determined upfront at the time of issue of the instrument. The price at the time of conversion should not in any case be lower than the fair value worked out, at the time of issuance of such instruments, in accordance with the extant FEMA rules.

**1.3.9 Share warrant:**

In case of share warrants, their pricing and the price/conversion formula shall be determined upfront. The price at the time of conversion should not in any case be lower than the fair value worked out, at the time of issuance of such warrants.

**1.3.10 Non-applicability of pricing guidelines:**

Pricing guidelines would not be applicable in the following cases:

(a) Investment in Equity Instruments by a PROI on Non-repatriation basis.

(b) Transfer by way of sale done in accordance with SEBI regulations where the pricing is prescribed by SEBI. A Chartered Accountant's certificate to the effect that relevant SEBI regulations/guidelines have been complied with has to be attached with form FC-TRS filed with the AD Bank.

***1.4 Restructuring Provisions:***

**1.4.1 FDI by swap of shares:**

An Indian Company may issue Equity Instruments to a PROI under automatic route if the Indian investee company is engaged in a sector under automatic route or with prior Government approval if the Indian investee company is engaged in a sector under government route against swap of Equity Instruments. The term 'Equity Instruments' is defined to mean equity shares, convertible debentures/preference shares issued by an Indian company. Therefore, an interpretation of FDI by swap of share would be acquisition of Equity Instruments by an Indian company from non-resident shareholders against issue of Equity Instruments to the non-resident shareholders as consideration.

**1.4.2 Merger or demerger or amalgamation of Indian companies:**

In case a scheme of merger or amalgamation of two or more Indian companies or a reconstruction by way of demerger or otherwise of an Indian company is approved by the National Company Law Tribunal ('NCLT')/ Competent Authority, the transferee company or the new company, as the case may be, can issue equity instruments to the existing holders of the transferor company who are resident outside India, subject to the following conditions:

(1) The transfer/issue should comply with entry routes, sectoral caps or investment limits, as the case may be, and the attendant conditionalities of foreign investment as well as reporting in form FC-GPR or FC-TRS as the case may be.

(2) In case the foreign investment is likely to breach the sectoral caps or the attendant conditionalities, the transferor company or the transferee or the new company should obtain necessary Government approval.

(3) The transferor company or the transferee company or the new company should not be in a sector prohibited for foreign investment.

(4) In a scheme of merger or amalgamation of two or more Indian companies or a reconstruction by way of demerger or otherwise of an Indian company, where any of the companies involved is listed on a recognised stock exchange in India, the scheme of arrangement should be in compliance with the SEBI (Listing Obligations and Disclosure Requirements) Regulations, 2015, as amended from time to time.

**1.4.3 Rights/Bonus Issue:**

PROI having investment in an Indian company is permitted to invest in the equity instruments (other than share warrants) issued by such company as a rights issue or a bonus issue subject to fulfilment of various conditions provided in the NDI Rules including adherence of sectoral cap.

It may be noted that the equity instruments (other than share warrants) acquired by the PROI as bonus or rights issue will be subject to the same conditions including restrictions with regard to repatriability as applicable to the original holding against which rights or bonus issue has been made. Further, the nature of investment (FDI or FPI) shall remain the same as that of original investment against which rights were issued.

Also, an individual who is a PROI exercising a right which was issued when he was a person resident in India can hold the equity instruments so acquired on exercising the right on a non-repatriation basis.

**1.4.4 Issue of shares by Wholly Owned Subsidiary ('WOS'):**

A WOS set up in India by a non-resident entity, operating in a sector where 100% foreign investment is allowed under the automatic route and there are no FDI linked performance conditions, may issue equity instruments to the said non-resident entity against pre-incorporation/preoperative expenses incurred by the said non-resident entity up to a limit of 5% of its authorised capital or USD 500,000 whichever is less, subject to the condition that within 30 days from the date of issue of equity instruments but not later than 1 year from the date of incorporation, Form FC-GPR is filed by the Indian company.

**1.4.5 Issue of Shares for non-cash considerations:**

An Indian company may issue equity instruments to the PROI under automatic route if the Indian investee company is engaged in a sector under automatic route or with prior Government approval if the Indian investee company is engaged in a sector under Government route against:

- Import of capital goods/machinery/equipment (excluding second-hand machinery) subject to fulfilment of various conditions such as import is made in accordance with Foreign Trade Policy etc.
- Pre-operative/pre-incorporation expenses (including payments of rent etc.), subject to fulfilment

of various conditions such as verification and certification of the pre-incorporation/pre-operative expenses by the statutory auditor, submission of Foreign Inward Remittance Certificate ('FIRC') for remittance of funds by the overseas promoters for the expenditure incurred etc.

**1.4.6 Deferred Payment Consideration:**

In case of transfer of equity instruments between a PRII and a PROI:

- **Deferral**: An amount not exceeding 25% of the total consideration can be paid by the buyer on a deferred basis within a period not exceeding 18 months from the date of the transfer agreement.
- **Escrow Arrangement**: An amount not exceeding 25% of the total consideration can be settled through an escrow arrangement between the buyer and the seller for a period not exceeding 18 months from the date of the transfer agreement.
- **Indemnification**: An amount not exceeding 25% of the total consideration can be indemnified by the seller for a period not exceeding 18 months from the date of the payment of the full consideration.

## 2. FPI:

### *2.1 Investment by FPI in Equity Instruments:*

2.1.1 Foreign Portfolio Investors (FPIs) may purchase or sell equity instruments of an Indian company that are either currently listed or to be listed on a recognized stock exchange in India subject to following conditions:

- The total holding by each FPI should be less than 10% of the total paid-up equity capital of the Indian company on a fully diluted basis. The total holdings of all FPIs put together in the Indian company should not exceed 24% of paid-up equity capital on a fully diluted basis.
- With effect from April 1, 2020, the aggregate limit for foreign investments by FPI in Indian companies is aligned with the sectoral caps.
- FPIs exceeding the above-mentioned limits have the option of divesting their holdings within 5 trading days from the date of settlement of the trades resulting in the breach. In case the total holding of an FPI increases to 10% or more of the total paid-up equity capital on a fully diluted basis, the total investment so made by the FPI and its investor group shall be considered as investment under FDI route and the FPI and its investor group cannot make further portfolio investment in the concerned company.
- A question may arise as to whether an FPI can also invest via the FDI route separate from its portfolio investment scheme. In this regard, it may be noted that that FPIs cannot invest in unlisted shares under the FPI route. However, arguably, they would be entitled to invest under the FDI route. In this

regard, the Indian company would have to maintain separate records such as filing with RBI, valuation, etc., for the investments made by FPI through FDI route.

***2.2 Pricing:***

FPI is permitted to purchase equity instruments of an Indian company through public offer/private placement, subject to the following conditions:

(a) **In the case of a public offer**: The shares must be issued at a price not lower than the price at which shares are issued to residents.

(b) **In case of issue by private placement**: The price should not be less than the price arrived in terms of SEBI guidelines or not less than the fair price worked out as per any internationally accepted pricing methodology for valuation of shares on arm's length basis, duly certified by a SEBI registered Merchant Banker or Chartered Accountant, as applicable.

An FPI may undertake short selling as well as lending and borrowing of securities subject to such conditions as may be stipulated by RBI and SEBI from time to time.

**2.2.1 Mode of payment:**

The amount of consideration for purchase of equity instruments should be received from abroad through banking channels through inward remittance or out of funds held in a foreign currency account or a Special Non-Resident Rupee (SNRR) account maintained in accordance with the Foreign Exchange Management (Deposit) Regulations, 2016.

**2.2.2 Transfer of equity instruments by FPI:**

FPI may transfer equity instruments or units held by him in compliance with the conditions, if any, prescribed in the respective Schedules to NDI rules and subject to the terms and conditions specified therein and by the SEBI. Further, prior Government approval shall be obtained for any transfer in case the company is engaged in a sector which requires the Government approval.

**2.2.3 Remittance of sale proceeds:**

The sale proceeds (net of taxes) of the investments can be remitted outside India or credited to the foreign currency account or SNRR account of the FPI.

***2.3 Investment by FPI in instruments other than equity instruments:***

A FPI may purchase units of domestic mutual funds or Category III Alternative Investment Fund or offshore fund for which no objection is issued in accordance with the SEBI (Mutual Funds) Regulations, 1996, which in turn invest more than 50% in equity instruments on repatriation basis subject to the terms and conditions specified by SEBI and RBI.

An FPI may purchase units of REITs and InVITs on repatriation basis subject to the terms and conditions specified by SEBI.

**2.3.1 Mode of payment:**

The amount of consideration shall be paid as inward remittance from abroad through banking channels or out of funds held in a foreign currency account and/or a Special Non-Resident Rupee (SNRR) account maintained in accordance with the Foreign Exchange

Management (Deposit) Regulations, 2016.

**2.3.2 Remittance of sale proceeds:**

The sale proceeds (net of taxes) of units of REITs, InViTs and domestic mutual fund may be remitted outside India or credited to the foreign currency account or a SNRR account of the FPI.

***2.4 Investment by FPI in debt instruments:***

2.4.1 An FPI may invest in debt instruments in accordance with Foreign Exchange Management (Debt Instruments) Regulations, 2019 ('DI Regulations'). As per Schedule 1 of DI regulations, FPI may inter-alia purchase following debt instruments on repatriation basis subject to the terms and conditions specified by SEBU and RBI:

(a) non-convertible debentures/bonds issued by an Indian company;

(b) debt instruments issued by banks, eligible for inclusion in regulatory capital;

(c) Credit enhanced bonds;

(d) Listed non-convertible/redeemable preference shares or debentures issued in terms of Regulation 6 of DI Regulations which deals with shares issued pursuant to merger/demerger of Indian companies;

(e) Rupee denominated bonds/units issued by Infrastructure Debt Funds;

(f) Debt securities issued by (i) InvITs and (ii) REITs.

As per the DI Regulations, read with the SEBI (Foreign Portfolio Investors) Regulations, 2019, an FPI can invest in, among others, NCDs issued by an Indian company. The NCDs were earlier required to be mandatorily listed or to be listed. However, FPIs are now permitted to invest in unlisted NCDs as well.

**2.4.2 Mode of Payment:**

The amount of consideration for purchase of instruments by FPIs shall be paid out of inward remittance from abroad through banking channels or out of funds held in a foreign currency account and/or Special Non-Resident Rupee (SNRR) account maintained in accordance with the Foreign Exchange Management (Deposit) Regulations, 2016.

**2.4.3 Remittance/credit of sale/maturity proceeds:**

The sale/maturity proceeds (net of taxes) of instruments held by FPIs may be remitted outside India or may be credited to the foreign currency account or SNRR account of the FPI.

**3 Foreign Venture Capital Investor (FVCI) route**

As per the NDI Rules, "FVCI" means a Foreign Venture Capital Investor incorporated and established outside India and registered with SEBI under the Securities and Exchange Board of India (Foreign Venture Capital Investor) Regulations, 2000 ['SEBI (FVCI) Regulations'].

***3.1 Issue/Purchase of securities:***

- Rule 17 read with Schedule VII of the NDI Rules, 2019, permits an FVCI to purchase:

i. securities (not listed on a recognised stock exchange at the time of issue), of an Indian company engaged in the specified sectors[1].

ii. units of a Venture Capital Fund (VCF) or of a Category I Alternative Investment Fund (Cat-I AIF) or units of a scheme or of a fund set up by a VCF or by a Cat-I AIF.

iii. equity or equity linked instrument or debt instrument issued by an Indian startup, irrespective of the sector in which the startup is engaged.

- If the investment by an FVCI is in equity instruments of an Indian company, then sectoral caps, entry routes and attendant conditions shall apply.
- An FVCI may purchase the securities/instruments permitted for it either from the issuer of these securities/instruments or from any person holding these securities/instruments.
- An FVCI may invest in securities on a recognized stock exchange subject to the provisions of the SEBI (FVCI) Regulations.

***3.2 Pricing:***

An FVCI may acquire any security/instrument permitted for it from any person resident in or outside India at a price that is mutually acceptable to the buyer and the seller/issuer.

The key benefit that the FVCI route provides from FEMA perspective is exemption from the pricing guidelines stipulated under the FEMA Regulations.

***3.3 Mode of payment:***

The amount of consideration shall be paid as inward remittance from abroad through banking channels or out of funds held in a foreign currency account and/or a Special Non-Resident Rupee (SNRR) account maintained in accordance with the Foreign Exchange Management (Deposit) Regulations, 2016.

***3.4 Transfer of securities:***

An FVCI may transfer securities/instruments to any person resident in or outside India at a price that is mutually acceptable to the buyer and the seller. In case of sale to a person resident outside India, the buyer should be an eligible acquirer.

An FVCI may also receive the proceeds of the liquidation of VCFs or of Cat-I AIFs or of schemes/funds set up by the VCFs or Cat-I AIFs.

***3.5 Remittance of sale/maturity proceeds:***

The sale/maturity proceeds (net of taxes) may be remitted outside India or may be credited to the foreign currency account or SNRR account of the FVCI.

1. (i) Biotechnology (ii) IT related to hardware and software development (iii) Nanotechnology (iv) Seed research and development (v) Research and development of new chemical entities in pharmaceutical sector (vi) Dairy industry (vii) Poultry industry (viii) Production of bio-fuels (ix) Hotel-cum-convention centres with seating capacity of more than three thousand (x) Infrastructure sector.

***3.6 Reporting:***

When investment is made under Schedule I of the NDI Rules, 2019:

When the SEBI registered FVCI acquires shares of an Indian company under the FDI route, then such investments would be required to be reported in Form FC-GPR/FC-TRS, as applicable.

When investment is made under Schedule VII of the NDI Rules, 2019:

When the SEBI registered FVCI acquires shares of an Indian company under the FVCI route in compliance with Rule 16 read with Schedule VII of the NDI Rules, then filing of Form FC-GPR/FC-TRS would not be required. Such transactions would be reported by the custodian bank in their reporting format prescribed by RBI from time to time.

**B. Investment by a PRII in a Foreign entity ('Outbound/Overseas Investment'):**

Overseas Investments by Indian parties are governed by Foreign Exchange Management (Overseas Investment) Rules, 2022 ('OI Rules'), Foreign Exchange Management (Overseas Investment) Regulations, 2022 ('OI Regulations') and Foreign Exchange Management (Overseas Investment) Directions, 2022 ('OI Directions') (to be collectively referred to as 'OI Framework').

The OI Framework broadly provides two routes for carrying out investment in overseas entities viz. Overseas Direct Investment (ODI) and Overseas Portfolio Investment (OPI). Whether the investment in an overseas investment would be classified as ODI/OPI would primarily depend on the security in which investment is intended to be made and accordingly necessary conditions related thereto would be required to adhered to. For the purpose of this article, we have briefly touched upon some of the important parameters related to investment under ODI and OPI route.

**1. ODI:**

***1.1 Instruments under ODI route:***

Investment under the ODI route *inter-alia* includes:

- Acquisition of unlisted equity capital of a foreign entity; or
- Subscription as a part of MoA of a foreign entity; or
- Investment in 10% or more of the paid-up equity capital of a listed foreign entity; or
- Investment with control where investment is less than 10% of paid-up equity capital of the listed foreign entity.

The term 'equity capital' has been defined to mean equity shares or perpetual capital or instruments that are irredeemable or contribution to non-debt capital of a foreign entity which is in the nature of fully and compulsorily convertible instruments. Therefore, investment in any instrument which is redeemable or non-convertible or optionally convertible shall not be treated as ODI for the purpose of OI Framework.

***1.2 ODI by an Indian Entity:***

An Indian entity may make ODI for the purpose of undertaking bonafide business activity by way of:

i. Subscription as part of MOA or purchase of equity capital (listed/ unlisted);

ii. Acquisition through bidding or tender procedure;

iii. Acquisition of equity capital by way of rights issue or allotment of bonus shares;

iv. Capitalization of the amount due to the Indian Entity by the Foreign Entity where such remittance is permitted and does not require prior approval;

v. Swap of securities;

vi. Merger, demerger, amalgamation, or any scheme of arrangement

Total financial commitment made by an Indian entity in all the foreign entities taken together at the time of undertaking such commitment shall not exceed 400% of its net worth as on the date of the last audited balance sheet.

**1.3 *ODI by a Resident Individual:***

A resident individual may make or hold Overseas Investment by way of:

- ODI in an operating foreign entity not engaged in financial services activity and which does not have subsidiary or step-down subsidiary where the resident individual has control in the foreign entity.
- OPI, including by way of reinvestment.
- Overseas investment by way of capitalisation, swap of securities on account of merger/demerger, rights/ bonus, gift, and inheritance shall be categorised as ODI or OPI based on the nature of the investment.
- Sweat equity shares, minimum qualification shares and shares under ESOP scheme – In such cases, acquisition of less than 10% of the equity capital, whether listed or unlisted, of a foreign entity without control is treated as OPI.
- Overseas investments by the resident individual shall be subject to the overall ceiling under LRS.

**1.4 *Transfer/Liquidation:***

- As per Rule 17 of the OI Rules, PRII may transfer equity capital by way of sale to a PRII, who is eligible to make such investment, or to a PROI. The said transfer is subject to compliance with pricing guidelines and reporting requirements as provided under the OI Framework.
- In case the transfer is on account of merger/amalgamation/demerger/ buyback of foreign securities, such transfer or liquidation of the foreign entity, should have the approval of the competent authority as per the applicable laws in India or the laws of the host country.
- Any disinvestment by the Indian resident is subject to the following conditions:

  i. In case of full disinvestment of the foreign entity other than by way of liquidation, the Indian resident seller should not have any

outstanding receivable dues from the foreign entity in equity capital and debt (e.g. dues outstanding in nature of dividend, interest etc.)

ii. In case of any disinvestment (partial or full), the Indian resident seller must have stayed invested for at least 1 year from the date of making ODI.

iii. The above conditions for disinvestment will not apply in case of a merger/demerger/amalgamation between two or more foreign entities that are wholly-owned, directly or indirectly, by the Indian entity or where there is no change or dilution in aggregate equity holding of the Indian entity in the merged or demerged or amalgamated entity.

2. **Overseas Portfolio Investment:** OPI is defined as investments other than ODI, in foreign securities, but not in any unlisted debt instruments or any security issued by a person resident in India who is not in an IFSC. Further, it is provided under the OI Directions that OPI shall not be made in any derivatives unless otherwise permitted by RBI or any commodities including Bullion Depository Receipts (BDRs).

- An Indian entity may make OPI which shall not exceed 50% of its net worth as on the date of its last audited balance sheet.
- Listed Indian companies are permitted to make OPI including by way of reinvestment.
- Unlisted Indian companies however can only acquire equity capital by way of OPI by means of rights/bonus, capitalization of amount due, swap of securities or merger, demerger, amalgamation or any scheme of arrangement as per the applicable laws in India or laws of the host country.
- The investment (including sponsor contribution) in units of any investment fund overseas, duly regulated by the regulator for the financial sector in the host jurisdiction, is considered as OPI.
- Resident individuals can also make OPI up to the LRS limit of USD 2,50,000 per annum.

3. **Pricing Guidelines related to Overseas Investments**

- Any transaction between a PROI and a PRII or transaction between two PRII involving issue or transfer of equity capital of a foreign entity are required to adhere to the pricing guidelines, viz. to be transacted at a price arrived on an arms-length basis. Any such transaction between two non-residents are outside the ambit of the pricing guidelines.

4. **Financial Commitment by way of Debt**

- Under the OI Framework, an Indian entity is permitted to lend or invest in any debt instrument issued by a foreign entity or extend non-fund based commitment to or on behalf of a foreign entity (including its overseas step-down subsidiaries) subject to prescribed limits and below conditions:

(i) the Indian entity is eligible to make ODI;

(ii) the Indian entity has made ODI in the foreign entity;

(iii) the Indian entity has acquired control in such foreign entity at the time of making such financial commitment.

- The following are regarded as debt instruments as per Rule 5 of the OI Rules:

  i. Government bonds;

  ii. corporate bonds;

  iii. all tranches of securitisation structure which are not equity tranche;

  iv. borrowings by firms through loans; and

  v. depository receipts whose underlying securities are debt securities

- An Indian entity may lend or invest in any debt instruments issued by a foreign entity subject to the condition that such loans are duly backed by a loan agreement where the rate of interest shall be charged on an arm's length basis. Further, a resident individual shall not make financial commitment by way of debt.

**Concluding Remarks**

The rules and regulations related to FDI, FPI, ODI etc. are very dynamic. To adapt to the changing economic parameters and to deal with business requirements, FEMA regulations have undergone number of changes (whether involving liberalization or otherwise) over a period of time and this will continue in the times to come. For instance, for a very long time, warrants and partly paid-up shares were not considered as an eligible security in which foreign investment could be made. However, they are now encompassed within the definition of 'equity instruments,' which shows how FEMA regulations have evolved to align with the changes in business transaction practices.

It is crucial to recognize that the choice of any financial instrument is influenced by various factors, including the investor's commercial objectives in relation to their stake in the issuing company, the expected return on investment in terms of interest or dividends, the investment horizon etc. For example, an individual willing to take substantial risks for potentially high rewards might opt for investments in equity shares. Conversely, someone seeking fixed returns may choose a debt instrument like NCD. Alternatively, one may also consider making investment in CCDs, offering fixed return in the form of interest until the CCD gets converted into equity shares. Once the instrument is agreed upon between the issuer and the investor, it becomes essential to analyse the relevant rules and regulations under FEMA both at the time of making the investment as well as at the time of divesting the same. Executing transactions in accordance with the prevailing FEMA regulations is essential to achieve desired commercial objectives without inviting unnecessary complications.

SS-IV-44

# Financial Instruments & Stamp Duty Implications

Gopal Malpani
Advocate

**Overview**

***Financial Instruments:***

- ***Over view of the various financial instruments.***

  ***Types of Financial Instruments.***

  — *Conventional Instrument : Equity Shares, Preference Shares (RPS, CCPS or OCRPS), Debentures (CCD, or OCDS), Bonds, Warrants.*

  — *New Type of Instrument : Masala Bonds, Green Bonds, REITs (Real Estate Investment Trusts) and InvITs (Infrastructure Investment Trusts), Municipal Bonds, Zero Coupon Zero Principal Instrument.*

  ***Life cycle of Financial Instruments.***

- ***Important laws governing such financial instruments.***

  — *Companies Act : Certain relevant sections, rules, compliances and prescribed forms.*

  — *FEMA : Certain relevant provisions, prohibited sector, modes of investments and important filing with Reserve Bank of India.*

  — *Investor's protection regulations.*

  — *SEBI and policies planned by SEBI*

  — *Industry specific norms and laws.*

- ***Direct and indirect taxes.***

  — *Income Tax : Capital Gain tax rate and other applicable provisions.*

  *GST, Stamp duty.*

- ***Important factors.***

  *Place, Time, Consideration*

- *Mode of issuance.*
- *Modes of payment of stamp duty.*
- *Ground level challenges.*
- *Stamp duty adjudication and advantages.*
- *Existing provisions.*
- *Rates of stamp duty on certain instrument*

*Type of Financial Instrument suitable to any Business Organisation would be dependent on various factors.*

SS-IV-45

**Financial Instruments**

Finance is the lifeline of every business. It is like oxygen and supply of blood for overall inception, growth, existence and expansion of any business.

Without finance business will not have resources to pursue growth, it is just impossible to conduct any business without finance.

While finance is critical, it is also critical to understand the various modes or sources of finance, which makes it feasible and viable for ***Companies/ Business House*** (Party 1) to plan its financing and at same time makes it safe and attractive for ***Investors*** (Party 2).

With two parties in place there comes a need to capture precise understanding in writing, to protect each other's interest, to ensure timely and definite implementation of the planned activities and so comes the need of an ***INSTRUMENT*** for any financial transaction or activities.

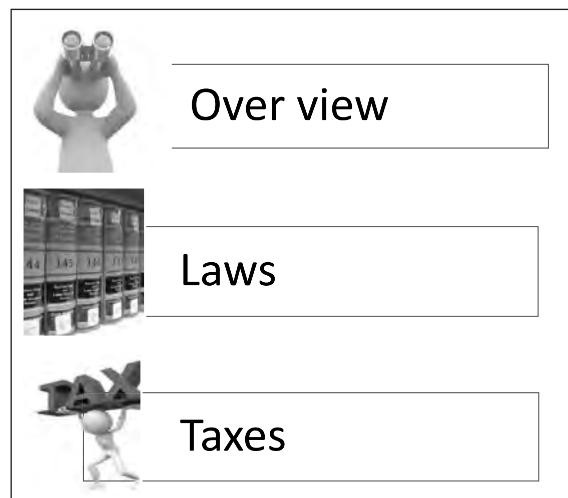
While evaluating financial requirement, it is important to understand ***options of raising finance*** available and apart from these options it is equally important to understand what ***best suits*** one's business organisation.

While understanding this it is also important to know ***legal compliances*** for various ***modes of finance.***

Raising finance and meeting financial requirements is important and ***timely repayment*** along with ***adequate profits and returns*** to investors is equally important for business organisation to ***create its brand image*** and value and persistent growth and future expansion.

And to give effect to smooth flow of financial transactions for either parties, financial instruments plays a significant and critical role.

**Parts of this article:**




- **Overview** of the various financial instruments.
- Important **laws** governing such financial instruments.
- **Taxes:** both Direct and indirect taxes critical for such financial instruments.
- ***Over view*** of the various financial instruments.
  - — Types of Financial Instruments.
  - — Life cycle of Financial Instruments.

A financial instrument is an ***agreement*** between ***two parties*** with ***monetary value***. In other words, any asset that holds capital and which can be traded (as the case may be in open market or otherwise) is a financial instrument. It can be palpable or virtual documents representing a legal agreement of any monetary value.

Typically, Financial Instruments can be determined by its modes and can be categorised or differentiated such as:

- Long term or short-term source.
- Debt or equity in nature.

- Marketable or non-marketable.

**Types of Financial Instruments:**

**Conventional Instruments:**

- **Equity Shares.**
  Essentially having voting rights in the company that is ownership in the company.

- **Preference Shares (RPS, CCPS or OCRPS).**
  May not have voting rights, but have first right to dividend over and above equity and have fixed returns

- **Debentures (CCD, or OCDS).**
  Debt instrument or a Loan (may be convertible to equity or preference or redeemable).

  It contains a contract for repayment of principal after a specified period or at intervals or at the option of the company and for payment of interest at a fixed rate payable usually either half-yearly or yearly on fixed dates.

- **Bonds**
  Any instrument whereby a person obliges himself to pay money to another, on condition that the obligation shall be void if a specified act is performed, or is not performed, as the case may be."

- **Warrants (No specific reference under Companies Act 2013).**
  This needs a little more elaboration as no specific reference has been made under the Companies Act 2013.

  Share Warrants are actually written options to subscribe to the shares of a Company on pre agreed terms at a future date, which are very common in the corporate world on account of the benefits associated.

  Seems under present amendment to the Companies Act, there is no precise reference to Share Warrants, however such warrants are recognised directly or indirectly under various provisions of law:

  The definition of "Securities" as provided for in section 2(h) of the Securities Contracts (Regulation) Act also includes rights or interest in securities.

  Share warrants are in fact a right to acquire securities in future date.

  The Foreign Exchange Management (Non Debt Instruments) Rules, 2019 also refers to the term Share Warrants, within overall definition of "Equity instruments",

  Further even Companies Act under section 68 dealing with buy back of securities and also reference to employee stock option are by nature equivalent to share warrants.

Also certain new types of instruments such as:

1. **Masala Bonds**

Masala Bonds serve as a financial instrument through which Indian entities can raise money from overseas markets in the local currency, the Indian Rupee. These bonds are a gateway for investors seeking exposure to Indian assets, thus contributing to the diversification of funding sources for issuers. Masala Bonds are rupee-denominated bonds issued by Indian entities outside India to raise money in local currency from foreign investors. The bonds are issued in Indian currency rather than local currency, which means that if the rupee rate

falls, the investor will bear the loss. Usage of proceeds from these bonds have specific parameters and certain restrictions.

### 2. Green Bonds

A green bond is a **fixed-income instrument designed to support specific climate-related or environmental projects**. Green bonds may come with tax incentives to enhance their attractiveness to some investors. The phrase "green bond" is sometimes used interchangeably with "climate bonds" or "sustainable bonds." These bonds are typically asset-linked and backed by the issuing entity's balance sheet, so they usually carry the same credit rating as their issuers' other debt obligations. Green bonds represent a broader category of instruments related to projects with a positive environmental impact, while **climate bonds** specifically finance projects that reduce carbon emissions or alleviate the effects of climate change. Green bonds finance projects aimed at energy efficiency, pollution prevention, sustainable agriculture, fishery and forestry, the protection of aquatic and terrestrial ecosystems, clean transportation, clean water, and sustainable water management. They also finance the cultivation of environmentally friendly technologies and the mitigation of climate change.

### 3. REITs and InvITs

The **Real Estate Investment Trusts (REITs)** is a form of collective investment scheme that would enable an investor to invest in a portfolio of income-generating real estate assets, by purchasing units of it. Investment is made in assets such as shopping malls, office spaces, hotels, apartments and these assets are rented or leased with the aim of generating income for the unitholders, from the pool of funds contributed by them. It is similar to mutual funds; however, instead of securities, REITs have real estate assets, directly or indirectly, as their underlying investments. A REIT is set up in the form of a trust registered with the stock market regulator Securities and Exchange Board of India (SEBI).

**Infrastructure Investment Trusts (InvITs)** is a **Collective Investment Scheme** similar to a mutual fund, which enables direct investment of money from individual and institutional investors in infrastructure projects to earn a small portion of the income as return. The InvIT is designed as a tiered structure with Sponsor setting up the InvIT which in turn invests into the eligible infrastructure projects either directly or via special purpose vehicles (SPVs).The InvITs are regulated by the SEBI (Infrastructure Investment Trusts) Regulations, 2014.

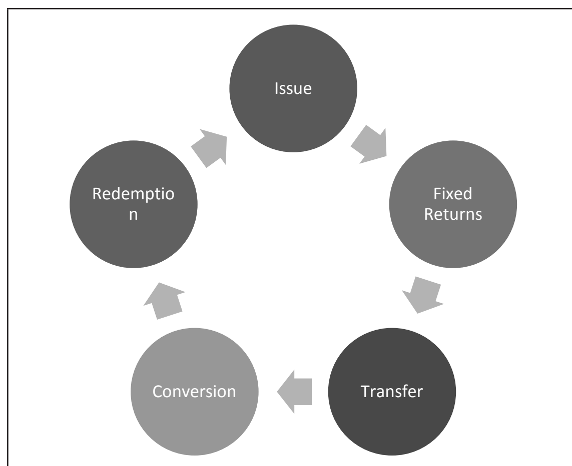
### 4. Municipal Bonds

A **Municipal Bond is a debt instrument issued by municipal corporations** or associated bodies in India. The funds raised through these bonds are utilized by the local government bodies to finance socio-economic development projects.

### 5. Zero Coupon Zero Principal Instrument

Zero Coupon Zero Principal Instrument means an instrument issued by a Not for Profit Organisation which shall be registered with Social Stock Exchange segment of a recognised Stock Exchange in accordance with the regulations made by the Securities and Exchange Board of India

**Typically any instruments would have a *life cycle* as under:**




1, **Issuance.**

Issuance is allotment of instrument to the investor.

2. **Catering to fixed returns/ annual returns as agreed**.

This amounts to providing return on investment to the Investors in form of Interest/ Dividend.

3. **Transfer.**

Investor may transfer its investment to some other investor before redemption for liquidity of funds.

4. **Conversion (as the case may be).**

Conversion of investment from one form to another, eg: conversion of Debenture into Equity shares.

5. **Redemption.**

Redemption is pay back of investment amount by Business House to the investor after the stipulated time period or some times even before that.

**Important laws governing such financial instruments.**

- Companies Act.
- FEMA.
- Investors protection regulations.
- Industry specific norms and laws.

**Direct and indirect taxes.**

- Income Tax.
- GST.
- Stamp duty.

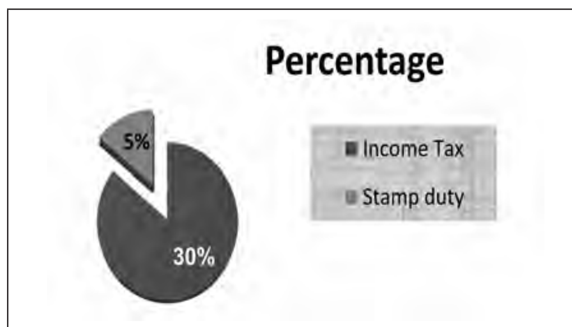
Under present article we would be discussing on stamp duty front that is:

- **Important factors.**
- **Modes of payment of stamp duty.**
- **Ground level challenges.**
- **Existing provisions.**
- **Rates of stamp duty on certain instrument**

**Stamp duty**

Stamp duty is an Indirect Tax, levied on instruments as defined under Indian Stamp Act and various State Stamp Act (mainly under section 3).

Stamp duty is often considered to be a subject with very minor impact on any instrument or transaction, compared to Income Tax, which may be fact when we look at the rates of chargeability.

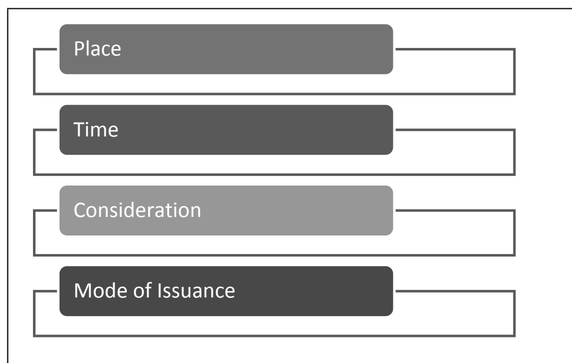



However, at times Stamp duty has a very large impact if not projected and planned before hand and may be a deal breaker or cause lot of hardship post transaction.

With increasing complexity of business models and finance requirement, stamp duty has become equally critical like any other tax, although in most cases it is an one-time event for any transaction of instrument.

Instruments not duly stamped are inadmissible as evidence. So, its mandatory to get every instrument adequately stamped.

Important **factors** to be considered for stamping of instrument:




1. **Place** of issuance of such instrument.

   Stamp duty is payable in the state where the instrument is issued and governed by specific state laws.

2. **Time** of issuance.

   Stamp duty is normally payable before issuance/signing of the instrument.

3. **Consideration** (being the issuance value and the conversion/ redemption value).

   Stamp duty is payable on the consideration value (as set out in the instrument) or the market value whichever is more

4. **Mode of issuance**.

   Mode of issuance is also critical to determine stamp duty, as in whether issued in physical or demat form.

Stamp duty payment options and various **modes of payment**.

1. **Online.**

   Normally through the portal provided by the respective State Government through Inspector General of Registration or also collected by Depository or Exchange.

2. **Offline.**

   Stamp paper/ franking.

3. **Hybrid mode.**

   It's a mode where in one makes online payment and then lodge documents/ instrument across counters at stamp office for endorsement.

**Ground level stamp duty challenges**:

SS-IV-50

Rates of Stamp duty on Issuance of Share certificate under demat form is 0.005% across India and rate of stamp duty as prescribed on physical issuance of shares by Central Government is also 0.005%. However under constitution Entry 91 of Union List, Part B, Issuance of shares is not vested with Central Government, therefore only State Government has power to levy stamp duty on physical issuance of shares therefore till today most of the states levy stamp duty on physical issuance of shares as per prevailing rates in those states.

There needs to be amendment introduced by respective states to give harmonious and consistent effect to such instruments.

Further there are many other challenges involved for transfer of such above referred financial instruments pursuant to Gift, Succession or Transfer as a part of restructuring as an investment in one of the transferor/ demerged company or transfer upon liquidation.

In case of Gift, if one executes a gift deed then the relevant stamp duty as applicable to the Gift under relevant stamp law may be applicable, which may be much higher than the actual stamp duty as applicable to the transfer of shares, although there is no consideration for transfer pursuant to the Gift, but still Gift deed attracts stamp duty. In some instances Stamp Duty on Gift deed may be as high as 3%.

Similarly, cases involving transfer pursuant to the restructuring such as amalgamation, merger demerger, may also attract stamp duty as per stamp laws prevalent in the respective state.

To sum up stamp duty in case of merger/ amalgamation/ restructuring of Companies would be as under in some of the states:

| State | On Shares & Consideration | On Immovable Properties | Upper Cap |
|---|---|---|---|
| Maharashtra | 0.7% | 5% | Rs. 50 crores/10% of shares & consideration |
| Gujarat | 1% | 1% | Rs. 25 crores |
| Telangana | 2% | Nil | Rs. 20 crores<br>*Amendment proposed |
| Karnataka | 1%<br>*Also on cancellation of shares | 3% (property) | Rs. 25 crores<br>*Amendment proposed |
| Madhya Pradesh | 0.5% | 5% | Rs.25 crores |
| Haryana | 1.5 % | 1.5% | Rs.7.5 crores |

In some instances, however transfer of financial instruments as part of investment undertaking pursuant to the restructuring such as merger/demerger/amalgamation/ arrangement may be beneficial from tax as well as stamp duty perspective.

Other important document is a ***Share Purchase Agreement*** (or any agreement pertaining to acquisition of financial instruments, capturing terms and conditions). There is ambiguity as

regards to the rate of stamp duty applicable on such instruments.

For instance in the state of Maharashtra such ***Share Purchase agreements (SPA)*** are covered under article 5(c) of the Maharashtra Stamp Act prescribing levy @ 0.01%. However, language used in this article is "marketable security" so then question arises is whether unlisted instruments are not covered in this article? If not, then which article would be applicable for SPA for such unlisted instruments?

Answer to the above questions could be either article 25 of the Maharashtra Stamp Act, which could be applicable to such SPA, pertaining to the conveyance of movable property, as such financial instruments could be considered as movable and then the applicable stamp duty could be at the rate of 3% of the market value or consideration and if not under article 25 then it could be under article 5(h)(iv) that is pertaining to "creation of any obligation, right or interest and having monetary value, but not covered under any other article, prescribing levy @0.2%.

So, in the above instance we can see that one instrument may attract 3 different rates that is @ 3% or 0.01% or 0.2%.

Similar challenges are also seen in other states apart from Maharashtra.

Other challenge is execution of instrument wherein same involves parties from two different states ***(set off)***.

While such cases have been addressed to some extent by Central Government for levy on shares transfer and certain other financial instruments transfer, but in above instance of Share Purchase Agreement one does face challenges as under:

- Stamp duty to be paid in state where it is executed.
- Once the document travels to other state for execution then stamp duty payable in that state as well.
- While section 19/19A of Stamp Act of most of the states provides set off and levy of only differential stamp duty.

But practically it is very difficult to avail such set off and many a times one ends up paying double duty or duty much higher than projected.

Further in many instruments it is possible that funds are raised in tranches, however if entire amount is mentioned on instrument, then stamp duty on entire amount mentioned in the instrument may be payable at inception itself.

Similar issue is with redemption if the issue price is lower, and the redemption price mentioned in the instrument is much higher then stamp duty may be levied at the redemption value mentioned which may be post facto and with certain contingencies attached to it.

**Stamp duty Adjudication**

In the event it is missed out to pay stamp duty on any financial instrument then same could be lodged for adjudication with the Collector of Stamps/ District Registrar within 30 days of issuance, if lodged beyond 30 days then same will attract additional penalty or interest, which may vary under respective state laws for instance penalty in Maharashtra is in form of interest which is 2% per month of the stamp duty amount and maximum upto 4 times of the stamp duty. Whereas penalty in states like Gujarat and Karnataka may extend upto 10 times of the stamp duty amount at the discretion of the adjudicating authorities, after giving reasonable opportunity of being heard to Assessee.

However certain authorities insist that while documents/ instruments with deficit stamp

duty could be adjudicated, but ones with no stamp duty paid could not be adjudicated.

Say for instance if one has paid Re1/- as stamp duty instead of Rs.100/- then same could be lodged for adjudication for deficit duty of Rs.99/- along with applicable penalty/ interest.

However, if one has not paid any duty then even if duty payable is Rs.100/- but same could not be adjudicated.

This is interpretation by some of the authorities although law is not very clear, but language used at many places for adjudication or impounding is deficit duty.

**Advantage of Stamp duty adjudication**

Stamp Duty Adjudication works as advanced ruling in many cases, wherein if there is ambiguity for the stamp duty computation or there is no certainty, then one can lodge the unexecuted instrument for adjudication before the Collector of Stamps or District Registrar and in the event one has an adverse outcome, the one has the option to withdraw the same, since it is not an executed instrument.

Further if the instrument is executed but not stamped or under stamped then same can be lodged within 30 days of execution for adjudication, in which case no interest or penalty would be levied.

Further adjudicated documents hold good in the eyes of law and even if reopened during course of audit for deficit stamp duty, the same will not attract interest or penalty at first demand.

**Appellate authorities**

In case a person is aggrieved from the adjudication order by Collector of Stamps or District Registrar then the immediate appellate authority would be CCRA or IGR

**Stamp duty Rates and pointers**

| ***Instrument*** | | ***Rate of Stamp duty*** |
|---|---|---|
| Shares issuance in demat form | | 0.005% |
| Transfer of Shares in physical form | | 0.015% |
| Transfer of Shares in Demat mode (in case of Sale of Shares through the Stock exchange) | | 0.015% in case on delivery basis<br>0.003% in case of non delivery basis |
| Derivatives: | | |
| (i) | Futures (equity and commodity) | 0.002% |
| (ii) | Options (equity and commodity) | 0.003% |
| (iii) | Currency and interest rate derivatives. | 0.0001% |
| (iv) | Other derivatives | 0.002% |
| Government securities | | 0% |
| Repo on corporate bonds | | 0.00001% |

*Please note that as discussed above issuance of shares in physical form may attract stamp duty at the rate as prevalent in respective states.

Each security is charged with a duty as specified in Schedule I of the Stamp Act. Securities are defined to include all those instruments specified in clause (h) of section 2 of the Securities Contracts (Regulation) Act, 1956; a "derivative" as defined in clause (a) of Section 45U of the Reserve Bank of India Act, 1934; a certificate of deposit, commercial usance bill, commercial paper and such other debt instrument of original or initial maturity up to one year as the Reserve Bank of India may specify from time to time; repo on corporate bonds; and any other instrument as may be declared by the Central Government, by notification in the Official Gazette, to be securities for the purposes of this Act.

The stamp-duty on sale of securities, transfer of securities and issue of securities shall be collected on behalf of the State Government by the Stock Exchange or Clearing Corporation authorized or Depositories (authorized collecting agents). The Central Government has also notified the Clearing Corporation of India Limited (CCIL) and the Registrars to Issue and / or Share Transfer Agents to act as collecting agents.

For all exchange based secondary market transactions in securities, Stock Exchanges shall collect the stamp duty; and for off-market transactions (which are made for a consideration as disclosed by trading parties) and initial issue of securities happening in demat form, Depositories shall collect the stamp duty.

As per section 4(3) of the Indian Stamp Act, 1899, in the case of any issue, sale or transfer of securities, the instrument on which stamp-duty is chargeable through Stock Exchanges/ Depositories under section 9A shall be the principal instrument for the purpose of this section and no stamp-duty shall be charged on any other instruments relating to any such transaction. Thus, section 4(3) is not applicable for section 9B. Therefore, in case of issue of securities by the company or any other body corporate otherwise than through a Stock Exchange or Depository, stamp duty will also be additionally applicable on other associated instruments such as share certificates etc. if provided for in the relevant Act/ Rules/ Notifications/ Guidelines governing the stamp duty collection of the concerned State.

Type of Financial Instrument suitable to any Business Organisation would be dependent on various factors such as:

- Time duration for which finance is required.
- Risk taking appetite of the promoters.
- Willingness to dilute stake.
- Legal compliances.
- Capacity to cater to the returns on investment.
- Segment of target investors.
- Cost attached to it.
- Compliances with Debt equity ratio as desired and permissible.

While this article tries to cover some important aspects about financial instruments, along with detailed note on stamp duty on such instruments however it is a very vast subject and it is not practically possible to cover all the aspects.

SS-IV-54

# Accounting for financial instruments from an Issuer's perspective under IGAAP and Ind AS

CA Siddharth Iyer CA Saurabh Mathur

**Overview**

*The advent of Ind AS (Indian Accounting Standards converged with IFRS) has significantly impacted the presentation, classification and measurement of financial instruments such as preference shares, debentures, bonds etc. with detailed guidance available under the Ind AS standards.*

*Currently under Indian GAAP, there is no comprehensive literature which deals with the presentation, classification and measurement of such instruments from the issuer's perspective. Presentation of instrument is based on their form. For e.g., irrespective of the contractual terms, preference shares (even if redeemable) are presented within equity and debentures/bonds (even with conversion features) are presented as liabilities. Similarly, limited guidance is available under Indian GAAP for derivative instruments issued by an entity.*

*The guidelines for appropriate classification, recognition and measurement of financial instruments is classifying a financial instrument from issuer's perspective into financial liabilities and equity instruments are outlined in Ind AS 32, Financial Instruments: Presentation.*

*In order for an instrument to be classified as an equity instrument under Ind AS 32, the number of equity instruments delivered, and the consideration for them, must be fixed – the so called 'fixed for fixed' requirement. Contracts that will be settled other than by delivery of a fixed number of shares for a fixed amount of cash do not generally meet the definition of equity. The initial and subsequent recognition as well as measurement of financial instruments is governed by Ind AS 109, Financial instruments.*

*This article discusses various financial instruments and their accounting from an issuer's perspective.*

## Introduction

The advent of Ind AS (Indian Accounting Standards converged with IFRS) has significantly impacted the presentation, classification and measurement of financial instruments such as preference shares, debentures, bonds etc. with detailed guidance available under the Ind AS standards. Careful

evaluation is needed for determination of the accounting for such instruments by the issuer. Convertible instruments such as convertible preference shares or bonds present a unique challenge as they may include characteristics of both equity as well as liability.

Currently under Indian GAAP, there is no comprehensive literature which deals with the presentation, classification and measurement of such instruments from the issuer's perspective. Presentation of instrument is based on their form. For e.g., irrespective of the contractual terms, preference shares (even if redeemable) are presented within equity and debentures/bonds (even with conversion features) are presented as liabilities. As mentioned earlier, such instruments need to be analysed further under Ind AS to determine appropriate accounting treatment.

Similarly, there is some limited guidance available for accounting of derivatives under Indian GAAP

The subsequent sections discuss the accounting of certain common financial instruments under Indian GAAP and Ind AS for various types of financial instruments by the issuer of such instruments.

## Guidance under Indian GAAP (IGAAP)

Under IGAAP there are no specific accounting standards which govern the accounting of financial instruments.

The presentation and disclosure of financial instruments like equity shares, preference shares, debentures and bonds are done as per the requirements of Schedule III of Companies Act, 2013.

Below is the summary of disclosure as per the guidance under IGAAP compliant schedule III:

| Instrument | Presentation |
|---|---|
| Equity shares | To be presented as a part of Share Capital |
| Preference shares | To be presented as a part of Share Capital |
| Debentures | To be classified and presented as borrowings |
| Bonds | To be classified and presented as borrowings |

Further, for derivatives over own equity, there is no specific guidance available in IGAAP.

## Guidance under Ind AS

The guidelines for classifying a financial instrument from issuer's perspective into financial liabilities and equity instruments are outlined in Ind AS 32, Financial Instruments: Presentation. The objective of Ind AS 32 is to establish principles for presenting financial instruments as liabilities or equity. It applies to the classification of financial instruments, from the perspective of the issuer, into financial assets, financial liabilities and equity instruments.

In order to classify a financial instrument between liability and equity, understanding the concepts of liability and equity is crucial.

A **financial liability** is any liability that is:

(a) a contractual obligation:

   i. to deliver cash or another financial asset to another entity; or

   ii. to exchange financial assets or financial liabilities with another entity under conditions that are potentially unfavourable to the entity; or

(b) a contract that will or may be settled in the entity's own equity instruments and is:

   i. a non-derivative for which the entity is or may be obliged to deliver a variable number of the entity's own equity instruments; or

   ii. a derivative that will or may be settled other than by the exchange of a fixed amount of cash or another financial asset for a fixed number of the entity's own equity instruments.

An **equity instrument** is any contract that evidences a residual interest in the assets of an entity after deducting all of its liabilities.

Instruments may also have a component of both - liability and equity, these components will be classified and presented separately, and such instruments are commonly termed as compound instruments. This concept is commonly known as split accounting.

The initial and subsequent recognition as well as measurement of financial instruments is governed by Ind AS 109, Financial instruments.

Subsequent sections explain the accounting of various financial instruments under IGAAP and Ind AS.

### 1. Debentures and bonds

Debentures and bonds are financial instruments which represent a form of long-term debt issued by a company. Such instruments may have various terms and conditions attached to them relating to the interest rates, redemption terms, and convertibility features. The accounting for such instruments depends on the terms and require careful evaluation. A few common types of debentures and their accounting is discussed below.

#### *Compulsory convertible debentures (CCDs)*

CCDs are debentures with an inherent feature of being converted into equity after a certain period of time or upon the occurrence of a predetermined event. The difference in accounting between IGAAP and Ind AS can be demonstrated through the following example.

***Example 1*** - A Ltd. issues 10 CCDs with a face value of INR 100 each which carries a fixed coupon of 8% paid each year to the investors during the 5 year tenure of the CCDs. At the end of 5 years the CCDs will be converted into equity shares in the ratio 1:1 i.e one equity share will be issued for each CCD on conversion. The prevailing market rate of interest for similar debentures without the conversion feature is 12%.

#### *Accounting under IGAAP*

There is no guidance available under IGAAP for accounting of CCDs in specific. The guidance under Schedule III to the Companies Act, 2013, requires that debentures are presented under liabilities as a part of borrowings and thus there is no requirement of split accounting (i.e., bifurcation of equity and liability component) under IGAAP.

The interest is charged to the profit and loss account. On maturity the CCDs are derecognised and the resultant equity shares are reflected as part of the Share Capital.

#### *Accounting under Ind AS*

Under Ind AS, the instrument needs to be analysed further.

Analysing the definition of a financial liability, it can be noted that financial liabilities include any contractual obligation to pay cash or to deliver a 'variable' number of own equity instruments to settle a contract. The obligation to pay a fixed coupon meets the criteria for financial liability classification, since there is a contractual obligation to pay cash which A Ltd. cannot avoid. Analysing the conversion feature it can be noted that the CCD is convertible into a 'fixed' number of shares, since each CCD can be converted into one ordinary equity share of A Ltd., on conversion. Therefore, the entire instrument cannot be classified as a financial liability while there is an obligation to pay cash for the coupon, there is no obligation to deliver a 'variable' number of own equity shares.

Instead, the element of conversion of CCDs will be separated and classified as equity as it meets the fixed-for-fixed criteria i.e., the debentures are convertible into a fixed number of equity shares.

The value of the financial liability is derived first. For the purpose of initial recognition, the present value of fixed coupon interest outflow on the CCDs will be considered as a financial liability and reduced from the total proceeds of the issue of CCDs. The residual value after deducting liability component is allocated to equity. The discount rate used to compute the present value is taken to be the prevailing market interest rate for similar debentures without the conversion option. This can be illustrated through computations below:

| **Calculation of liability and equity components in issuer's books** | | | |
|---|---|---|---|
| **Year** | **Cash out flow** | **DF (12%)** | **NPV** |
| 1 | 80 | 0.89 | 71 |
| 2 | 80 | 0.80 | 64 |
| 3 | 80 | 0.71 | 57 |
| 4 | 80 | 0.64 | 51 |
| 5 | 80 | 0.57 | 45 |
| Present value of cash obligation (to be accounted as liability component) | | | 288 |
| Proceeds received on issue – 10 x INR 100 | | | 1,000 |
| /Value of the equity component (Residual amount) [1000 less 288] | | | 712 |

The initial journal entry to record the above transaction shall be as under:

| Bank/Cash | Dr. | 1,000 |
|---|---|---|
| To financial liability | Cr. | 288 |
| To equity | Cr. | 712 |

In subsequent years, the liability will be reduced to zero on payment of interest in each year.

| **Value of financial liability** | | | | |
|---|---|---|---|---|
| **Year** | **Liability opening balance** | **Interest (12%)** | **Interest paid** | **Liability closing balance** |
| 1 | 288 | 35 | (80) | 243 |
| 2 | 243 | 29 | (80) | 192 |
| 3 | 192 | 23 | (80) | 135 |
| 4 | 135 | 16 | (80) | 71 |
| 5 | 71 | 9 | (80) | Nil |
| | Total finance cost | 112 | | |

SS-IV-58

The journal entry in Year 1 to record the interest charge to the profit and loss account and the payment of interest will be as under:

| Interest charge to P&L | Dr. | 35 |
|---|---|---|
| Financial liability | Dr. | 80 |
| To financial liability | Cr. | 35 |
| To bank/cash | Cr. | 80 |

Similar entries will be recorded for each of the remaining years, till the entire financial liability is paid off.

As can be seen from above the total interest cost recorded in the profit and loss statement over 5 years is INR 112.

The equity component is not subsequently remeasured. On conversion at the end of Year 5, this amount of INR 712 will be allocated to equity share capital and securities premium account.

In Example 1, however, if the conversion terms of CCDs at the end of 5 years were changed such that each CCD would be converted into variable number of equity shares derived on the basis of fair market value of equity share prevailing as on the date of conversion i.e. number of equity shares to be issued on conversion will be determined by dividing the CCD value with the fair market value of one equity share as on date of such conversion, the fixed-for-fixed criteria will not be met. In this scenario, the CCDs will be classified as a financial liability in their entirety and no split accounting will be done.

**Optionally convertible debentures or bonds (OCDs/OCBs)**

Optionally convertible debentures or bonds provide the holder a flexibility to choose either redemption in cash or conversion in equity shares. From an issuer's perspective, optionally convertible instruments that are convertible at the option of the holder will always have a liability element, since there is a contractual obligation to deliver cash, in case the holder does not convert.

In such situations as well, split accounting will be done, with the instrument being split into a financial liability and equity component. The accounting done will be similar to Example 1 as discussed earlier. The total expected cash outflow including interest and principal repayment shall be present valued, using a discount rate, to determine the value of the financial liability first. After reducing this value from total proceeds received, the residual value will be considered as equity.

Till now we have considered situations, where the holder has the right to ask for conversion or redemption. However, there can also be a situation, where only the issuer has the right to either settle the instrument in cash or in shares. The holder does not have the right to demand either redemption or conversion. The accounting in the issuer's books in this case can be discussed below through an example.

***Example 2*** - A Ltd. issues 10 OCBs with a face value of INR 100 each which carries a fixed coupon of 8% to the investors during the 5 year tenure. A ltd. (not the investor) has an option to convert the bonds into a fixed number of own equity shares at any time before maturity. A similar instrument with no conversion option is available at a coupon rate of 12%. If OCBs are not converted before maturity then the principal and unpaid accrued interest will be repaid in cash at maturity. The investors do not have the right to demand conversion or redemption.

| **Calculation for the purpose of classification in issuer's books** | | | |
|---|---|---|---|
| ***Year*** | ***Cash out flow*** | ***DF (12%)*** | ***NPV*** |
| 1 | 80 | 0.89 | 71 |
| 2 | 80 | 0.80 | 64 |
| 3 | 80 | 0.71 | 57 |
| 4 | 80 | 0.64 | 51 |
| 5 | 1080 | 0.57 | 613 |
| Present value of cash obligation | | | 856 |
| Proceeds received on issue | | | 1,000 |
| Balancing amount | | | 144 |

There could be two accounting views regarding the classification of such an instrument:

<u>Treat the contract with financial liability and equity component</u>: A Ltd. can classify this instrument as a liability, being a hybrid instrument comprised of two components:

a. host liability component for the obligation to pay the mandatory coupons and to repay the principal amount at maturity i.e., INR 856 in the above example; and

b. an(equity) component for the company's option to settle the instrument early in a fixed number of its own shares. The derivative component will be assigned a value of INR 144 i.e., proceeds received less the present value of cash obligation of A ltd. as calculated above.

OR

<u>Treat the host contract as equity:</u> The host contract can be viewed as an equity instrument as the issuer has the ability to convert the instrument into a fixed number of its own shares at any time and has the ability to avoid making a cash payment or settling the instrument in a variable number of its own shares. In this case the entire instrument will be classified as equity instrument and total proceeds received will be accounted as equity.

**2. Preference shares**

Preference shares represent a type of ownership in a company that comes with certain rights and preferences over equity shares. The key features of preference shares include preferential dividends, fixed dividends, differential voting rights. Common types of preference share are convertible preference shares, redeemable with different dividend pay-out options. Accounting under IGAAP and Ind AS are explained in subsequent sections.

***Accounting under IGAAP***

There is very limited guidance available under IGAAP for accounting of preference shares and the is no specific accounting standard that governs the accounting for preference shares. As per guidance note to Schedule III, of the Companies Act, 2013, preference shares are to be presented within equity. For preference share capital, there could be different classes of shares such as Compulsorily Convertible Preference Shares, Optionally Convertible Preference Shares, etc. Preference shares are to be disclosed under the head 'Share Capital', separate from equity share capital.

Further Schedule III requires disclosure of the amount of dividends proposed to be distributed to preference shareholders for the period and the related amount per share to be disclosed separately under Contingent liabilities and commitments. It also requires

separate disclosure of the arrears of fixed cumulative dividends on preference shares.

**Accounting under Ind AS**

Accounting under Ind AS would of types of preference shares under Ind AS can be demonstrated better with the help of below examples:

Redeemable preference shares (RPS) – The amount of a mandatory redeemable preference share is repaid at the end of its tenure to the holders of the instrument. Generally, RPS also carries a fixed coupon. A preference share that provides for mandatory redemption by the issuer for a fixed or determinable amount at a fixed or determinable future date or gives the holder the right to require the issuer to redeem the instrument at or after a particular date for a fixed or determinable amount is a financial liability. The accounting for this type of preference share is explained in below example:

***Example 3*** - A Ltd. issues 10 redeemable preference with a face value of INR 100 each which carries a fixed coupon of 8% to the investors during the 5 year tenure. A Ltd. will redeem the preference shares at a premium of 20% at the end of its tenure. This type of preference shares is classified as a financial liability and it will be accounted using effective interest rate (EIR) method. The EIR is equivalent to a rate which discounts the future cash outflows flows equal to the initial inflow. The following table depicts the calculations.

| *Year* | *Cash inflow* | *Op. bal. of liability* | *Interest cost (using EIR method) for the year @ 11.20%* | *Coupon and principal repayment* | *Cl. bal. of liability* |
|---|---|---|---|---|---|
| 1 | 1000 | 1,000 | 112 | (80) | 1,032 |
| 2 | | 1,032 | 116 | (80) | 1,068 |
| 3 | | 1,068 | 120 | (80) | 1,107 |
| 4 | | 1,107 | 124 | (80) | 1,151 |
| 5 | | 1,151 | 129 | (1,280) | - |

The preference shares will be initially recorded as a financial liability equal to the amount of proceeds received. Interest cost will be charged to profit and loss account in respective years as per above calculation till the entire instrument is redeemed.

**Optionally convertible preference shares (OCPS)**

In case of OCPS, where the preference shares are either redeemable or convertible at the option of the holder, the terms should be analysed to ascertain whether the conversion is into a fixed number of entity's own shares or variable number of shares. Where the instrument is convertible into a fixed number of shares, it is a compound instrument with characteristics of both equity and financial liability and split accounting shall be followed.

***Example 4*** - Consider an example where A Ltd. issues 10 OCRPs with a face value of INR 100 each which carries a fixed coupon of 8% to the investors during the 5 year tenure. The holder has an option to either redeem the preference shares at the time of maturity or to convert the preference shares into equity shares in a 1:1 ratio. Similar instrument with

no conversion option is available at a coupon rate of 12%. If OCRPs are not converted or redeemed before maturity then the principal and unpaid accrued interest will be repaid in cash at maturity.

First the value of financial liability is determined, assuming the full term of the instrument:

| **Calculation for the purpose of determining the value of financial liability** | | | |
|---|---|---|---|
| **Year** | **Cash out flow** | **DF (12%)** | **NPV** |
| 1 | 80 | 0.89 | 71 |
| 2 | 80 | 0.80 | 64 |
| 3 | 80 | 0.71 | 57 |
| 4 | 80 | 0.64 | 51 |
| 5 | 1080 | 0.57 | 613 |
| Present value of cash obligation considered as financial liability | | | 856 |
| Proceeds received on issue of preference shares | | | 1,000 |
| Balancing amount considered as equity | | | 144 |

As can be seen from the above table. The initial value of financial liability is determined to be INR 856. The amount of equity is considered to be INR 144, which is the residual value from proceeds. The initial journal entry for recording the instrument will be:

| Bank/Cash | Dr. | 1,000 |
|---|---|---|
| To financial liability - OCPS | Cr. | 856 |
| To equity | Cr. | 144 |

In subsequent years the liability will be carried at amortised cost and the equity component is not subsequently remeasured.

See below for computation relating to the liability:

| **Value of financial liability** | | | | |
|---|---|---|---|---|
| **Year** | **Liability opening balance** | **Interest (12%)** | **Interest paid** | **Liability closing balance** |
| 1 | 856 | 103 | (80) | 879 |
| 2 | 879 | 105 | (80) | 904 |
| 3 | 904 | 108 | (80) | 933 |
| 4 | 933 | 112 | (80) | 965 |
| 5 | 965 | 116 | (80) | 1,000 |

The liability at the end of the fifth year is INR 1,000. The holder may either redeem or convert. Accordingly, the journal entry recorded shall be:

| Financial liability – OCPS | Dr. | 1,000 |
|---|---|---|
| To equity or cash & bank | Cr. | 1,000 |

There may be other variations to the terms and conditions, which will impact the classification and initial recognition of the preference shares. A few are discussed below:

a) Preference shares with discretionary dividends that are redeemable at the option of the issuer at some future date may be considered as equity instruments, since, there is no contractual obligation to pay cash or deliver a variable number of own equity shares

b) a) Mandatorily redeemable preference shares with discretionary dividends may be considered as a compound instrument i.e. instrument with both characteristics of financial liability (because there is a contractual obligation to pay cash on redemption) and equity (discretionary dividends)

SS-IV-62

c) Redeemable preference shares, redeemable at the holder's option at some future date with discretionary dividends are also treated as compound instruments

### 3. Modification accounting for financial liability

Sometimes, the terms of a financial instrument may get restructured or renegotiated. To account for such changes, modification accounting under Ind AS 109: Financial Instruments, is applied. At the time of renegotiation, there may be changes to the contractual cash flows of the instrument's amount and/or timing of the cash flow. In order to apply modification accounting, it is crucial to examine whether the modification is substantial or not.

If the modification is substantial, then the old instrument is derecognised and a new financial liability is recognised.

***Modification of terms that result in derecognition***

A modification is considered as substantial, if the net present value of the cash flows under the new terms (including any net fees paid) discounted using the original effective interest rate (EIR) differs by at least 10 per cent from the present value of the remaining cash flows under the original terms.

As per the guidance under Ind AS 109, in case the modification is substantial then a financial liability is derecognised and a new financial liability is recorded. Any difference between carrying amount of old liability and modified liability is recognised as gain or loss in profit and loss account.

***Example for modification:*** An entity issues 1,000 convertible preference shares at the start of year 1. The bonds have a five-year term and are issued at par with a face value of INR 500 per share. So total proceeds from issue are INR 500,000. Interest is payable annually in arrears at an interest rate of 8%. Each share is convertible at maturity into 250 equity shares. At the time of issue, the prevailing market interest rate for similar debt without conversion options is 10%.

At the end of 2nd year, the interest rate on bonds is changed to 3%.

| **Calculation of liability and equity components** | | | |
|---|---|---|---|
| **Year** | **Cash out flow** | **DF (10%)** | **NPV** |
| 1 | 40,000 | 0.91 | 36,364 |
| 2 | 40,000 | 0.83 | 33,058 |
| 3 | 40,000 | 0.75 | 30,053 |
| 4 | 40,000 | 0.68 | 27,321 |
| 5 | 5,40,000 | 0.62 | 3,35,298 |
| Present value of cash obligation (to be accounted as liability component) | | | 4,62,092 |
| Proceeds received on issue | | | 5,00,000 |
| Amount allocated to equity component (Balancing amount) | | | 37,908 |

The computations in the above table have been performed using the original EIR and the original projected cash flows. The carrying value of the financial liability as at end of year 2 is measured at INR 4,75,131 as below.

| ***Financial liability amortisation schedule*** | | | | |
|---|---|---|---|---|
| ***Year*** | ***Op. bal.*** | ***Interest (@10%)*** | ***Repay-ments*** | ***Cl. Bal.*** |
| 1 | 4,62,092 | 46,209 | (40,000) | 4,68,301 |
| 2 | 4,68,301 | 46,830 | (40,000) | 4,75,131 |
| 3 | 4,75,131 | 47,513 | (40,000) | 4,82,645 |
| 4 | 4,82,645 | 48,264 | (40,000) | 4,90,909 |
| 5 | 4,90,909 | 49,090 | (5,40,000) | - |

As required by Ind AS 109, to assess whether modification accounting is to be performed, the modified cash flows of Year 3,4 and 5, are discounted to present value using the original EIR, as below and compared against the carrying value as of end of Year 2.

| **Calculation of liability based on revised terms** | | | |
|---|---|---|---|
| **Year** | **Cash out flow** | **DF (10%)** | **NPV** |
| 3 | 15,000 | 0.91 | 13,636 |
| 4 | 15,000 | 0.83 | 12,397 |
| 5 | 5,15,000 | 0.75 | 3,86,927 |
| Net present value of the cash flows under the new terms discounted using the original EIR | | | 4,12,960 |
| Present value of the remaining cash flows under the original terms. | | | 4,75,131 |
| Change (in amount) | | | 62,171 |
| Percentage Change | | | 13% |

In the above example, the change in the amount of financial liability obligation is more than 10% and thus the modification will be considered as substantial. The carrying amount of liability component of CCPS i.e., INR 4,75,131 will be derecognised and a new liability component of CCPS i.e., INR 4,12,960 will be recognised. This will result in a gain of INR 62,171 and the same will be recognised in profit and loss account.

***Modification of terms that do not result in derecognition***

As per the guidance under Ind AS 109, in case the modification is not substantial, an entity recalculates the gross carrying amount of the financial liability and recognises a modification gain or loss in profit or loss.

In the above example, if the interest rate at the end of year 2 is changed to 7%, the revised liability component of CCPS will be recalculated to INR 4,62,697. The change in the amount of financial liability obligation will not be more than 10% (in the instant case 3%) and thus the modification will not be considered as substantial. The carrying amount of liability component of CCPS i.e., INR 4,75,131 will be adjusted to reflect the revised amount of liability component of CCPS. This will result in a modification gain of INR 12,434 and the same will be recognised in profit and loss account.

### 4. Derivatives over own equity – call and put options, forwards and share warrants

Derivatives over own equity shares can take various forms, but generally are either forward contracts, call or put options or share warrants.

***Call option:*** A call option is a financial contract that gives the holder the right, but not the obligation, to buy a specified amount of an underlying asset (such as issuer Company's equity shares) at a specified price (the strike price) within a specified period of time. The seller of the call option, also known as the writer, has the obligation to sell the asset to the call option holder if the holder decides to exercise the option.

***Put option:*** A put option is a financial contract that provides the holder with the right, but not the obligation, to sell a specified amount of an underlying asset (such as issuer Company's equity shares) at a specified price (the strike price) within a specified period of time. The seller of the put option, also known as the writer, has the obligation to buy the asset from the put option holder if the holder decides to exercise the option.

***Forward contract***: A forward contract, is a contract agreement to buy or sell an asset (such as issuer Company's equity shares) at a specific price on a specified date in the future.

***Share warrants:*** A share warrant gives the holder the right to purchase a Company's stock at a specific price and at a specific date. A share warrant is issued directly by the company concerned; when an investor exercises a share warrant. In other words, the shares that fulfil the obligation are not received from another investor but directly from the issuer Company.

From an issuer's perspective, a share warrant is similar to a written call option. As the accounting considerations are similar for such type of transactions, accounting for share warrants has not been separately analysed.

### *Accounting under IGAAP*

There is no specific guidance that governs the accounting for call and put options or other forms of derivative contracts over issuer Company's own equity shares. Consequently, it has been noticed that there are varied views with respect to the accounting for such transactions.

One view is to record the transaction as and when the option is exercised (i.e. accounted as issue or buy-back of issuer's own equity shares as appropriate). If the option is not exercised, the transaction is not reflected in the IGAAP financial statements. There could be other views as well, which includes accounting as per other GAAPs/Guidance Notes.

It would be inappropriate to conclude that an accounting policy choice is available with respect to accounting for such transactions. Based on careful evaluation of all facts and circumstances specific to the transaction, an appropriate accounting policy may have to be applied. It is recommended that the regulators or ICAI provide guidance on how to account for such transactions.

### *Accounting under Ind AS:*

An entity might enter into a derivative contract for the purchase or sale of its own equity instruments. Depending on the nature of the contract (forward-based or option-based) and the settlement terms (for example, gross or net, and in cash or own equity instruments), such contracts could be accounted for as equity instruments, financial liabilities or as derivative assets and liabilities. Guidance with respect to accounting for such transactions is discussed below:

1. Derivative contracts (e.g. call and put options and forward contracts) over entity's own equity instruments, where settlement is not exclusively by an exchange of a fixed number of shares for a fixed amount of cash, do not meet the definition of equity instruments as per Ind AS 32 and are, in general, treated as derivative financial assets or liabilities. Ind AS 109 requires such contracts to be accounted for at fair value through profit or loss.

2. A derivative contract over an entity's own equity meets the definition of equity as per Ind AS 32, if it is settled exclusively by an exchange of a fixed number of shares for a fixed amount

of cash. Any premium received or paid with respect to such instruments are added or deducted directly from equity. Subsequent changes in fair value of the equity instrument are not recognised in the financial statements.

Exception to the above rules applies to forward contracts and written put options with an obligation/option to settle gross (transaction price can either be fixed or variable). Entering into a gross-settled contract for the purchase of own equity instruments gives rise to a financial liability (measured at present value of redemption price) in respect of the obligation to pay the purchase or redemption price, but resulting, on initial recognition, in a reduction of equity rather than an expense.

The following table summarizes the application of derivatives over equity with different settlement mechanisms. The settlement terms have also been explained below.

a) Net cash settlement: When the net gain/loss on the derivative contract is settled in cash and no shares are exchanged.

b) Net share settlement (shares for shares): When variable number of shares is delivered wherein the fair value of the shares delivered equals the net gain/loss on the derivative contract.

c) Gross physical settlement. Exchange of shares in return of shares.

d) Settlement options: When either the issuer or the holder has a right to choose between two or more of the above ways of settlement.

| S.no | Type of contract | No of shares | Amount of functional currency cash | Net cash settlement only | Net share settlement only | Gross physical settlement only | Settlement options with counterparty (i.e not the issuer) |
|---|---|---|---|---|---|---|---|
| 1. | Forward contract to buy | Fixed or variable | Fixed or variable | Derivatives - FVTPL | Derivatives - FVTPL | Financial liability at present value of repurchase price | Financial liability at present value of repurchase price |
| 2, | Forward contract to sell | Fixed | Fixed | Derivatives – FVTPL | Derivatives – FVTPL | Equity | Derivatives - FVTPL |
| 3. | Forward contract to sell | Fixed | Variable | Derivatives - FVTPL | Derivatives – FVTPL | Derivatives - FVTPL | Derivatives - FVTPL |
| 4. | Forward contract to sell | Variable | Fixed | Derivatives - FVTPL | Derivatives - FVTPL | Derivatives - FVTPL | Derivatives - FVTPL |
| 5, | Forward contract to sell | Variable | Variable | Derivatives - FVTPL | Derivatives - FVTPL | Derivatives - FVTPL | Derivatives - FVTPL |
| 6, | Purchased call option | Fixed | Fixed | Derivatives – FVTPL | Derivatives – FVTPL | Equity | Derivatives - FVTPL |
| 7, | Purchased call option | Fixed | Variable | Derivatives – FVTPL | Derivatives – FVTPL | Derivatives – FVTPL | Derivatives – FVTPL |

| S.no | Type of contract | No of shares | Amount of functional currency cash | Net cash settlement only | Net share settlement only | Gross physical settlement only | Settlement options with counterparty (i.e not the issuer) |
|---|---|---|---|---|---|---|---|
| 8. | Purchased call option | Variable | Fixed | Derivatives – FVTPL | Derivatives – FVTPL | Derivatives – FVTPL | Derivatives – FVTPL |
| 9. | Purchased call option | Variable | Variable | Derivatives – FVTPL | Derivatives – FVTPL | Derivatives – FVTPL | Derivatives – FVTPL |
| 10. | Written call option | Fixed | Fixed | Derivatives – FVTPL | Derivatives – FVTPL | Equity | Derivatives - FVTPL |
| 11. | Written call option | Fixed | Variable | Derivatives – FVTPL | Derivatives – FVTPL | Derivatives – FVTPL | Derivatives – FVTPL |
| 12. | Written call option | Variable | Fixed | Derivatives – FVTPL | Derivatives – FVTPL | Derivatives – FVTPL | Derivatives – FVTPL |
| 13. | Written call option | Variable | Variable | Derivatives – FVTPL | Derivatives – FVTPL | Derivatives – FVTPL | Derivatives – FVTPL |
| 14. | Purchased put option | Fixed | Fixed | Derivatives – FVTPL | Derivatives – FVTPL | Equity | Derivatives - FVTPL |
| 15. | Purchased put option | Fixed | Variable | Derivatives – FVTPL | Derivatives – FVTPL | Derivatives – FVTPL | Derivatives – FVTPL |
| 16. | Purchased put option | Variable | Fixed | Derivatives – FVTPL | Derivatives – FVTPL | Derivatives – FVTPL | Derivatives – FVTPL |
| 17, | Purchased put option | Variable | Variable | Derivatives – FVTPL | Derivatives – FVTPL | Derivatives – FVTPL | Derivatives – FVTPL |
| 18, | Written put option | Fixed or variable | Fixed or variable | Derivatives - FVTPL | Derivatives - FVTPL | Financial liability at present value of repurchase price | Financial liability at present value of repurchase price |

The concepts enumerated above can be better understood through illustrative examples with journal entries as explained below.

**1) Accounting for derivative on own equity – FVTPL instrument**

***Example 5 - Written call option on own equity shares (net cash settled):***

On 1 July 2023, Entity A enters into a contract with Entity B that gives Entity A the obligation to deliver and Entity B the right to receive the fair value of 800 of Entity A's own equity shares as of 1 October 2023 in exchange for INR 200,000 in cash (250 per share), if Entity B exercises that right. The contract will be settled net in cash. The face value of the shares is INR 10 per share.

a) ***Initial recognition (1 July 2023):***

On the date of entering into a written call option with Entity B, a call option liability at the FV as on that date will be recorded

by Entity A. Assuming the Fair value (representing option premium received) as on 1 July 2023 is INR 12,000, a call option liability will be recorded at the said amount. Below journal entry will be passed by Entity A:

| Bank (representing option premium received) | Dr. | 12,000 |
|---|---|---|
| To Call option liability | Cr. | 12,000 |

b) ***At reporting date (30 Sept 2023):***

As on the reporting date, a call option liability will be remeasured at its fair value and a gain/loss will be recorded in profit and loss account. Assuming the Fair value (liability) as on 30 September 2023 is INR 40,000, a loss of INR 28,000 will be recorded by Entity A. Below journal entry will be passed by Entity A:

| Loss on FV of call option liability | Dr. | 28,000 |
|---|---|---|
| To Call option liability | Cr. | 28,000 |

c) ***On settlement date (1 October 2023):***

As on the exercise date, Entity B exercise its right under the option to receive the cash on the basis of FV of the share and the contract is settled net in cash. Assuming the fair value of Entity A's share is INR 300 per share, Entity A will have an obligation to deliver cash of INR 40,000 [800 shares *(300-250)]. Below journal entry will be passed by Entity A:

| Call option liability | Dr. | 40,000 |
|---|---|---|
| To bank | Cr. | 40,000 |

***Note***:

i. In case the transaction is settled net in own equity shares instead of cash, the credit will go to other equity. In this case, 133 shares (rounded-off for convenience) will be issued (INR 40,000/300 shares).

**2) Accounting for derivative on own equity – equity instrument**

Example 6 - Written call option on own equity shares (gross settled):

Assume the same facts as in example 5) above, except that the transaction is gross settled instead of net settled.

a) ***Initial recognition (1 July 2023):***

On the date of entering into a written call option with Entity B, any premium received is recorded directly within equity and is not subsequently remeasured. As stated above, the fair value (representing option premium received) as on 1 July 2023 is INR 12,000. Below journal entry will be passed by Entity A:

| Bank (representing option premium received) | Dr. | 12,000 |
|---|---|---|
| To other equity | Cr. | 12,000 |

b) ***At reporting date (30 September 2023):***

A derivative contract over an entity's own equity meets the definition of equity as per Ind AS 32 is not subsequently remeasured.

c) ***On settlement date (1 October 2023):***

On the settlement date, Company B will exercise the option of purchasing 800 shares by paying the strike price of INR 250 per share. Below journal entry will be passed by Entity A:

| Bank (800 shares * INR 250 per share) | Dr. | 200,000 |
|---|---|---|
| Other Equity (800 shares * INR 250 per share) | Cr. | 200,000 |

**Note:** This article does not specify in which line item of other equity, the debit or credit should be recorded. Ind AS does not contain any specific guidance in this respect, however consideration should be given to the requirements of the Companies Act 2013 and/ or any other regulation as may be relevant.

### 3) Accounting for derivative on own equity – Present value of gross liability

***Example 7 - Written put option (gross settled):***

On 1 April 2022, Entity A enters into a contract with Entity B that gives Entity B the right to sell, and Entity A the obligation to buy 800 of Entity A's own equity shares as of 1 April 2023 at an exercise price of 250 per share. If the put option is exercised, the contract will be gross settled by Entity B selling 800 shares to Entity A and Entity A paying Entity B INR 250 per share in cash (total INR 200,000). Assume discounting rate of 10% p.a.

a) ***Initial recognition (1 April 2022):***

On the date of entering into a written put option contract with Entity B, any premium received is recorded directly within equity and the put option is not subsequently remeasured. The fair value (representing option premium received) of the option as on 1 April 2022 is INR 12,000. Below journal entry will be recorded by Entity A:

| Bank (representing option premium received) | Dr. | 12,000 |
|---|---|---|
| To other equity | Cr. | 12,000 |

With respect to a written put option contract which will be settled gross, Ind AS 32 requires that on initial recognition a financial liability should be recorded for an amount equal to the present value of the redemption amount. The corresponding debit is generally recorded within other equity. The amount payable at the end of 1 year is INR 200,000 (800 shares * INR 250 per share) and the present value of this amount discounted at 10% p.a. is INR 181,818. Below journal entry will be recorded by Entity A:

| Other equity | Dr. | 181,818 |
|---|---|---|
| To financial liability | Cr. | 181,818 |

b) ***At reporting date (31-March-2023)***

At reporting date, the put option is not subsequently remeasured. However, interest expenses will be accredited to gross-up the financial liability to the amount payable on redemption.

| Interest expenses | Dr. | 18,182 |
|---|---|---|
| To financial liability | Cr. | 18,182 |

c) ***At settlement date (1-April-2023)***

Assuming the put option is exercised by Company B, Company A will be required to pay INR 200,000 and buy-back 800 shares. Below journal entry will be passed by Entity A:

| Financial liability | Dr. | 200,000 |
|---|---|---|
| To bank | Cr. | 200,000 |

***Notes:***

i. it is assumed that the shares bought back by Entity A are not cancelled. In case, the shares are cancelled, equity share capital should be debited and other equity credited for an amount equal to the par amount of own equity shares cancelled.

ii. This article does not specify in which line item of other equity, the debit or credit should be recorded. Ind AS does not contain any specific guidance in this respect, however consideration should be given to the requirements of Company Act 2013 and/or any other regulation as may be relevant.

Derivative over own equity is a complex area, requiring careful evaluation of all facts and circumstances specific to the transaction and application of appropriate guidance under Ind AS, to properly reflect the transaction in the issuer's financial statements.

### 5. Equity shares

Equity shares, also known as common stock or ordinary shares, represent ownership in a company. When an investor holds equity shares in a company, they become a shareholder and own a portion or share of that company.

#### *Accounting under IGAAP*

There is no specific standard that governs the accounting of equity shares. The equity shares are generally accounted at its face value i.e., historical cost. Premium collected on issue of shares is recorded as securities premium within equity.

As per the IGAAP compliant schedule III, the equity shares issued by a company are separately presented as share capital of the company under the section shareholder's fund in the balance sheet.

The amount of dividends proposed to be distributed to equity shareholders for the period and the related amount per share shall be disclosed separately under contingent liabilities and commitments.

#### *Accounting under Ind AS*

The accounting of equity instruments is governed by Ind AS 109. The equity shares are generally accounted at its face value i.e., historical cost. Premium collected on issue of shares is recorded as securities premium within equity. Cost incurred for issuance of shares is accounted as a deduction from equity.

As per schedule III, the equity shares issued by a company are separately presented as equity share capital of the company under the section equity in the balance sheet.

The amount of dividends proposed to be distributed to equity shareholders for the period are accounted within equity as appropriation to profits.

### Conclusion

As seen from the analysis and examples above, a company may issue various types of complex financial instruments, which may have a significant impact on accounting – classification, recognition, initial and subsequent measurement and sometimes valuations as well. Wherever considered necessary, one should seek appropriate advice with respect to the accounting and valuation of such instruments.

# Navigating the Art and Science of Valuation

CA Paras K. Savla

**Overview**

*Valuation, the process of determining the worth of an asset or a company, is a critical aspect of the financial landscape. Whether it's assessing the value of a business for a potential sale, estimating the worth of securities, or evaluating the fair value of tangible assets, the art and science of valuation play a pivotal role in decision-making across various industries. In this article, we delve into the intricacies of valuation, exploring the approaches, methodologies, and factors that contribute to this nuanced practice. Valuation, is an art, not an exact science. Mathematical certainty is not demanded nor indeed is it possible – Viscount Simon, an acknowledged authority of all times on income-tax law of England Gold Coast Selection Trust Ltd. vs. Humphrey [1949] 17 ITR (Suppl.) 19 (HL).*

## 1. Valuation Approaches

### a. *Income Approach*

The income approach values an asset based on its income-producing capability. Methods like Discounted Cash Flow (DCF) and Capitalization of Earnings fall under this category, emphasizing the present value of future cash flows.

### b. *Market Approach*

The market approach relies on comparing the asset with similar assets in the market. Comparable Company Analysis (CCA) and Precedent Transaction Analysis (PTA) are common methods, providing a benchmark by considering market prices and multiples.

### c. *Asset-Based Approach*

This approach assesses the value of assets and liabilities, focusing on the net asset value. Particularly relevant for tangible assets and real estate, this approach is vital in determining the value of a company's equity.

## 2. Methodologies in Valuation

### a. *Discounted Cash Flow (DCF)*

DCF is a widely used method that involves projecting future cash flows and discounting them back to present value. It requires careful consideration of growth rates, discount rates, and terminal values.

### b. *Comparable Company Analysis (CCA)*

CCA involves comparing financial ratios and multiples of a target company to those of similar, publicly traded companies. This method requires access to a comprehensive database of comparable companies.

SS-IV-71

### c. *Precedent Transaction Analysis (PTA)*

PTA looks at the multiples paid in similar transactions, providing insights into what acquirers have been willing to pay for comparable assets. It considers the acquisition prices of similar companies.

## 3. Factors Influencing Valuation

### a. *Market Conditions*

Economic conditions, industry trends, and market volatility significantly impact the valuation of assets. Understanding the broader market context is crucial for accurate assessments.

### b. *Company-Specific Factors*

The unique characteristics of a company, including its growth prospects, competitive position, management team, and risk profile, play a pivotal role in valuation.

### c. *Regulatory Environment*

Valuation practices are often subject to regulatory frameworks and accounting standards. Adhering to these regulations is essential for maintaining transparency and compliance.

## 4. Technology and Valuation

### a. *Data Analytics*

The advent of data analytics has revolutionized the valuation process. Advanced modeling techniques and big data analytics enable more accurate predictions and assessments.

### b. *Machine Learning*

Machine learning algorithms can analyze vast datasets, identifying patterns and trends that may not be immediately apparent. This technology enhances the precision of valuation models.

## 5. Industry-Specific Considerations

### a. *Real Estate Valuation*

Real estate valuation involves assessing factors such as location, property condition, and market demand. Methods like the Comparable Sales Approach and Income Capitalization Approach are common.

### b. *Startup Valuation*

Startups, often lacking historical financial data, may require unique valuation methods like the Risk Factor Summation approach or the Berkus Method, which consider qualitative aspects.

Valuation is an intricate dance between art and science, requiring a deep understanding of financial principles, market dynamics, and the unique attributes of the asset or company in question. Whether it's a seasoned financial analyst evaluating a publicly traded company or an entrepreneur determining the value of their startup, the principles of valuation serve as a compass in the complex world of finance. As technology continues to advance, so too will the sophistication of valuation methodologies, ensuring that this essential practice remains at the forefront of informed decision-making in the ever-evolving global economy.

## Broad contents of valuation report

A valuation report is a comprehensive document that communicates the methods, assumptions, and findings of the valuation process. It serves to provide stakeholders with a clear and transparent understanding of how the valuation was conducted and the factors that influenced the final value. While the specific contents may vary based on the nature of the valuation and applicable standards, here is a general outline of what a valuation report may include:

***1. Executive Summary:***

- Brief overview of the valuation purpose and objectives.
- Summary of key findings and the final valuation conclusion.
- Any significant assumptions or limitations.

***2. Introduction***

- Background information on the entity being valued.
- Purpose of the valuation (e.g., merger and acquisition, financial reporting, tax purposes).
- Scope of the valuation engagement.

***3. Valuation Approaches and Methods***

- Explanation of the approaches used (Income Approach, Market Approach, Asset-Based Approach).
- Detailed discussion of the specific valuation methods employed (Discounted Cash Flow, Comparable Company Analysis, etc.).
- Rationale for selecting particular methods based on the nature of the subject being valued.

***4. Financial Analysis***

- Historical and forecasted financial statements, if applicable.
- Analysis of key financial metrics, ratios, and trends.
- Consideration of any non-recurring items or extraordinary circumstances affecting financial performance.

***5. Market and Economic Analysis***

- Overview of relevant economic conditions and industry trends.
- Analysis of market conditions, including supply and demand factors.
- Identification of comparable companies or transactions in the case of market-based approaches.

***6. Risk Factors***

- Assessment of specific risk factors that may impact the valuation.
- Discussion of how risk was incorporated into the valuation models.

***7. Discounts and Premiums***

- Explanation of any discounts applied (e.g., for lack of control, lack of marketability).
- Consideration of any premiums, such as control premiums.

***8. Assumptions and Limitations***

- Clear statement of the key assumptions made during the valuation.
- Disclosure of caveats, limitations and disclaimers to the extent they explain or elucidate the limitations faced by valuer.

***9. Valuation bases***

A valuer is required to adopt valuation bases prescribed by regulations or as agreed upon between the parties i.e.

- Fair Value.
- Participant Specific Value.
- Liquidation Value.

***10. Premises of Value***

Explain Premise of Value refers to the conditions and circumstances how an asset is deployed i.e.

- Going Concern Value.

- As is where basis.
- Orderly liquidation
- Forced Transaction

***11. Valuation Results***

- Presentation of the final valuation conclusion.
- Explanation of the determined value and any ranges or sensitivity analyses considered.

***12. Conclusion and Recommendations***

- Summary of key points from the report.
- Any recommendations or considerations for stakeholders based on the valuation results.

***13. Appendices***

- Detailed supporting information, such as additional financial data, relevant agreements, or industry reports.
- Calculation details for key valuation inputs and outputs.

***14. Certification and Compliance***

- A statement of compliance with relevant valuation standards or guidelines.
- A statement of compliance with independence of valuer.
- Signatures and qualifications of the individuals responsible for the valuation.

**Compliance with Valuation Standards**

Valuation standards are fundamental guidelines and principles established to ensure consistency, transparency, and reliability in the process of determining the worth of assets, businesses, or financial instruments. These standards provide a framework for valuation professionals, accountants, and financial analysts, offering a common language and methodology for assessing the value of various entities. Valuation standards play a pivotal role in ensuring the integrity and reliability of valuation processes. They provide a structured framework for practitioners, offering a set of best practices that contribute to the consistency, transparency, and credibility of valuation outcomes. Whether established by global organizations, industry bodies, or regulatory authorities, adherence to these standards fosters trust and confidence in the valuation profession. Any valuation carried by a member of ICAI to follow the standards set by ICAI. In India no other institution has issued valuation standards. Many follow Standards issued by the International Valuation Standards Council.

**Regulatory Background**

On October 18, 2017, a significant amendment to the Companies Act, 2013, was introduced through the enactment of Section 247 and the Companies (Registered Valuers and Valuation) Rules, 2017. This marked the inception of the concept of a "Registered Valuer" (RV), signalling a move towards standardizing the valuation procedures in alignment with global standards.

Prior to these amendments, the valuation of a company's assets and liabilities in India lacked a well-defined and uniform framework. The absence of formal mechanisms contributed to a lack of structure in the valuation process. The introduction of Section 247 and associated rules was a commendable effort to address this gap and bring regulation to the valuation practices in the country.

While the Companies Act, 2013 covers valuation, it's noteworthy that various transactions may be subject to additional regulatory compliances outlined in different statutes. This complexity arises because a

single transaction may fall under the purview of multiple regulatory authorities. Instances where regulatory bodies such as FEMA, the Income Tax Department (as per the Income Tax Act, 1961), SEBI (under the Securities and Exchange Board of India Act, 1992), etc., are involved, they may assert their influence over the valuation process.

### A] Companies Act

#### *I. Registered Valuer under the Companies Act*

Historically, prior to the Companies Act of 2013, no other company law in India included provisions for valuation or specified who could undertake the responsibilities of a valuer. The introduction of Section 247 in the Companies Act marked a pivotal moment, establishing the framework for matters requiring valuation under this legislation.

Section 247 states that when there is a need to evaluate any property, stocks, debentures, shares, securities, goodwill, or other assets, as well as the net worth or liabilities of a company as per the Act's provisions, such valuation must be carried out by a "Registered Valuer."

The eligibility criteria for a "Registered Valuer" have been explicitly addressed by the Companies (Registered Valuers and Valuation) Rules, 2017 (the Rules), which also outline the process for obtaining the certificate to be recognized as a registered valuer. Additionally, the Rules designate the Insolvency and Bankruptcy Board of India (IBBI) as the "registering authority," responsible for conducting examinations and granting certifications for the qualification of a registered valuer. Any valuation carried under Companies Act 2013 is required to be undertaken by the Registered Valuer only.

#### *II. Practice of Valuation under the Companies Act*

Section 247(2) outlines the methodology for valuation under the Companies Act. It mandates that a registered valuer must conduct a fair, impartial, and accurate valuation of a company's assets subject to valuation requirements. The section also emphasizes the importance of due diligence during the valuation process, directing valuers to adhere to rules prescribed by the Ministry of Corporate Affairs.

In addition to the specified duties, Section 247(2) imposes restrictions on registered valuers, prohibiting them from valuing any asset in which they have a direct or indirect interest, or develop such an interest during or after the valuation.

Rule 16 of the Companies (Registered Valuers and Valuation) Rules, 2017, supplements these guidelines by stipulating valuation standards to be followed by registered valuers. The rule empowers the central government to notify valuation methods over time. Until such notification, registered valuers are required to adhere to either internationally accepted valuation methodologies, valuation standards endorsed by a valuation professional organization, or those specified by regulatory bodies such as the Reserve Bank of India or the Securities and Exchange Board of India.

According to the Companies Act, the price of shares to be issued on preferential basis is to be determined by the valuation report given by a registered valuer. The price of shares or other securities to be issued on preferential basis shall not be less than the price determined on the basis of valuation report of a registered valuer. A valuation report of the consideration received by a registered valuer shall also be attached along with the return of allotment.

Following are the sections of Companies Act, 2013 which require valuation by a registered valuer

| S. No. | Section | Particulars |
|---|---|---|
| 1 | 62(1)C | Valuation report for Further Issue of Shares |
| 2 | 192(2) | Valuation of Assets Involved in Arrangement of Non-cash transactions involving Directors |
| 3 | 230(2)(c)(v) | Valuation of shares, property, and assets of the Company under a scheme of Corporate Debt Restructuring |
| 4 | 230(3) | Valuation report along with Notice of creditors/shareholders meeting – Under the scheme of compromise/Arrangement. |
| 5 | 232(2)(d) | The report of the expert with regard to valuation, if any, would be circulated for the meeting of creditors/Members |
| 6 | 232(3)(h) | The Valuation report to be made by the tribunal for an exit opportunity to the shareholders of the transferor Company – Under the scheme of Compromise/Arrangement in case the Transferor company is a Listed Company and the Transferee-company is an unlisted Company. |
| 7 | 236(2) | Valuation of equity shares held by the Minority Shareholders. |
| 8 | 260(2)(C) | Preparing a valuation report in respect of shares and assets to arrive at the reserve price for a company Administrator |
| 9 | 281(1) | Valuing assets for submission of the report by the liquidator |

**B] Income Tax Act**

Various provisions of the Income-tax Act 1961 provides for the valuation of Shares and Securities. Income-tax Act (the 'Act') does not define the term 'Shares and Securities'. Certain provisions of the Act and Income-tax Rules 1962 (the 'Rules' or 'Rule') states that it shall have the same meaning as assigned to it under the Securities Contracts (Regulation) Act, 1956. Majority of the provisions under Income tax act where valuation of shares and securities/ business is required are as follows:

- Section 50CA – Transfer of unquoted shares
- Section 56(2)(viib) & 56(2)(x)(c) – Issue/ receipt of Shares
- Section 17(2) – ESOP/Sweat Equity
- Section 50B – Slump Sale
- Section 9(1)(i) Indirect transfer

Where a method has been prescribed by the legislature, that method alone shall be followed for computation of the fair market value. The legislature in its wisdom has also given a formula for the computation of the fair market value which cannot be ignored by the authorities below. The tax officer has to compute the fair market value following the prescribed method and he cannot adopt the market value as fair market value[1].

1. *Medplus Health Services (P.) Ltd. vs. ITO [2016] 68 taxmann.com 29/158 ITD 105 (Hyd. - Trib.)*

**I. Section 50CA i.e. Special provision for full value of consideration for transfer of share other than quoted share read with Rule 11UAA**

Where the consideration received or accruing as a result of the transfer by an assessee of a capital asset, being share of a company (other than a quoted share), is less than the fair market value of such share determined in accordance with provisions given under Rule 11UAA, the value so determined shall, for the purposes of section 48, be deemed to be the full value of consideration received or accruing as a result of such transfer.

If Consideration received or accruing < fair market value then,

Full value of consideration (FVOC) = FMV of Share, Provided that the provisions of this section shall not apply to any consideration received or accruing as a result of transfer by such class of persons and subject to such conditions as may be prescribed.

**II. The Fair Market Value of shares when issued at price exceeding face value u/s 56(2)(viib) and receipt of shares u/s. 56(2)(x)(c)**

***Issuance of Shares***

Sec 56(2)(viib) of the Act provides that in the case of a specified company, where shares are issued for consideration exceeding the fair market value of shares, then the consideration received in excess of the fair market value is taxable under the head 'Income from other sources'.

Prior to Finance Act, 2023 provisions of sec 56(2)(viib) were applicable only to the resident investors. However, effective A.Y. 2024-25, this section is amended to bring within its ambit consideration received from the non-resident investors as well.

For the ascertainment of fair market value of shares u/s. 56(2)(viib), Rule 11UA(2) is to be adopted. In line with amendment in sec 56(2)(viib), Rule 11UA has also been modified vide notification no. 81/2023 dated 25th September, 2023.

Prior to the amendment, Rule 11UA prescribed two methods of valuation of shares to the resident investors viz. Discounted Cash Flow (DCF) method and Net Asset Value (NAV) method. Now, post amendment, additional five methods of valuation are available to non-residents -

1. **Comparable Company Multiple Method:** The Comparable Company Multiple Method involves assessing the value of a subject company by comparing its financial metrics, such as earnings, revenue, or book value, with similar metrics of publicly traded comparable companies. This method is particularly useful in industries with a robust public market presence.

2. **Probability Weighted Expected Return Method:** The Probability Weighted Expected Return Method combines elements of risk and probability, calculating the expected return of an investment by considering different scenarios and assigning probabilities to each outcome. This method is valuable for assessing the potential outcomes of complex projects or investments with varying levels of risk.

3. **Option Pricing Method:** The Option Pricing Method applies principles from financial options to value an asset. This method is commonly used in the valuation of financial instruments, real options, and employee stock options. It involves assessing the flexibility and strategic options associated with an

investment, considering the potential for future uncertainties.

4. **Milestone Analysis Method:** The Milestone Analysis Method is often employed in the valuation of early-stage companies, particularly those in the technology and biotech sectors. This method assigns different values to a company based on the achievement of specific milestones, such as successful clinical trial results or product launches.

5. **Replacement Cost Method:** The Replacement Cost Method determines the value of an asset by assessing the cost of replacing it with a new equivalent. This method is commonly used for the valuation of tangible assets, such as real estate or machinery. It provides insights into the cost implications of recreating the asset at current market rates.

It is to be noted that valuation in all the methods except Net Asset Value method must be determined by the merchant banker only.

Where the shares under consideration are compulsorily convertible preference shares, the above mentioned methods are available to determine the fair value.

Additionally, a safe harbour of 10% variation in value is also provided.

The Net Asset value method is given below

| Sr No | Particulars | | Amount | Amount |
|---|---|---|---|---|
| 1. | Book value of all the assets (other than jewellery, artistic work, shares, securities and immovable property) as reduced by :- | | | |
| | (i) | Income-tax paid or Income-tax refund; | | |
| | (ii) | Unamortised amount of deferred expenditure (A) | xx | |
| 2. | Market value of jewellery and artistic works (B) | | | - |
| 3. | Fair market value of shares and securities (C) | | | - |
| 4. | The stamp duty value of the immovable property (D) | | | - |
| | Book value of liabilities, excluding the below:- | | | xx |
| | (i) | Paid up equity share capital | - | |
| | (ii) | The amount set apart for payment of dividends | - | |
| | (iii) | Reserves and surplus | - | |
| | (iv) | Provision for taxation | - | |
| | (v) | Provisions made for meeting liabilities, other than ascertained liabilities | - | |
| | (vi) | Contingent liabilities | - | |
| 5. | Book Value of Liabilities (L) | | xx | |
| 6. | Net Assets {(A)+(B)+(C)+(D)-(L)} | | xx | |

***Receipt of Shares***

In case of sec 56(2)(x)(c), where shares and securities are received either without consideration or inadequate consideration, such that the aggregate fair value of which exceeds fifty thousand rupees, then in such case scenario to the extent of inadequate or lack of consideration exceeds fifty thousand rupees, such sum is taxable under the head 'Income from other sources'.

Determination of fair value is done by adopting Rule 11UA(1)(c).

**Valuation of Compulsory Convertible Preference Shares**

The Amended Rule introduces provisions for the valuation of Compulsory Convertible Preference Shares (CCPS) and outlines the applicability of a safe harbour threshold. Under this amendment, an option is provided to utilize the fair market value (FMV) of unquoted equity shares as a benchmark for determining the FMV of CCPS.

Additionally, the rule incorporates a price matching facility. In the context of this facility, the price at which unquoted equity shares or CCPS are issued by company in which public is not substantially interested to notified Non-Resident (NR) entities, venture capital funds (VCF), or specified funds will be adopted as the FMV. This adoption serves as a standardized benchmark for the valuation of equity and CCPS investments, applicable to both resident and non-resident entities.

These amendments aim to bring clarity and uniformity to the valuation process, offering a structured approach that aligns with the fair market value of unquoted equity shares.

**III. Part C - ESOP/SWEAT EQUITY**

Employee Stock Options (ESOPs) have become a ubiquitous component of modern compensation packages, serving as a powerful tool to align the interests of employees with those of the company. As these options grant employees the right to purchase company shares at a predetermined price, understanding the valuation of ESOPs is crucial for both employers and employees. In this article, we delve into the intricacies of ESOP valuation, shedding light on the methods and considerations involved.

Section 17(2)(vi) of the Income Tax act provided for the taxability of the value of any specified security or sweat equity shares allotted or transferred, directly or indirectly, by the employer, or former employer, free of cost or at concessional rate to the assessee.

"Specified security" means the securities as defined in clause (h) of section 2 of the Securities Contracts (Regulation) Act, 1956), and, where employees' stock option has been granted under any plan or scheme therefor, includes the securities offered under such plan or scheme. The "option" means a right but not an obligation granted to an employee to apply for the specified security or sweat equity shares at a predetermined price.

"Sweat equity shares" means equity shares issued by a company to its employees or directors at a discount or for consideration other than cash for providing know-how or making available rights like intellectual property rights or value additions, by whatever name called.

***Valuation date (Income-tax)***

The fair market value of any specified security or sweat equity share, being an equity share in a company, on the date on which the option is exercised.

*Valuation methodology (Income-tax)*

**a) Share in the company is listed on a recognized stock exchange:**

On the date of the exercising of the option, the share in the company is listed on a recognized stock exchange, the FMV shall be the average of the opening price and closing price of the share on that date on the said stock exchange[2]. In case the share is listed on more than one recognized stock exchanges, the FMV shall be the average of opening price and closing price of the share on the recognised stock exchange which records the highest volume of trading in the share.

In case, there is no trading in the share on any recognized stock exchange on the date of exercising of the option, the fair market value shall be—

(i) the closing price of the share on any recognised stock exchange on a date closest to the date of exercising of the option and immediately preceding such date; or

(ii) the closing price of the share on a recognised stock exchange, which records the highest volume of trading in such share, if the closing price, as on the date closest to the date of exercising of the option and immediately preceding such date, is recorded on more than one recognized stock exchange.

However, no guidance is available in case share is not traded for a long time or is suspended for trading for various reason. Whether in such case too above suggested mechanism hold? Whether shares would be treated as unlisted?

**b) Share in the company is not listed on a recognized stock exchange:**

On the date of exercising of the option, the share in the company is not listed on a recognised stock exchange, the FMV shall be such value of the share in the company as determined on the date of exercise[3]. No guidelines have been prescribed as to how valuation is to be carried. Hence internationally accepted methodology, as well as principals, are required to be followed for the valuation of such ESOPs.

*Valuation carried by whom*

For the determination of FMV of the unlisted shares on the date of exercise of the option, valuation is required to be carried by the Merchant Banker. Valuation of ESOP is not required under the Act at the time of grant. However the same is required to be valued by the Registered Valuer under Companies Act for accounting treatment in the books of the employer company.

**Internationally Valuation Methods:**

***a. Black-Scholes Model:***

The Black-Scholes model is a widely recognized method for valuing European-style stock options. It considers factors such as the current stock price, option strike price, time to expiration, volatility, and risk-free interest rate. While popular, it may have limitations in capturing the complexity of ESOPs, especially those with unique features.

***b. Binomial Model:***

The binomial model offers a more flexible approach, accommodating variations in option terms and exercise patterns. This method is

2. Income-tax Rule 3(8)(ii)
3. Income-tax Rule 3(8)(iii)

particularly useful for valuing American-style options, allowing for adaptability in the face of changing market conditions.

***c. Monte Carlo Simulation:***

The Monte Carlo simulation involves running multiple simulations to model the uncertainty and variability in factors affecting option value. This method is advantageous for capturing the dynamic nature of ESOPs and accounting for various potential scenarios.

**Key Considerations in ESOP Valuation**

***a. Vesting Period***

The vesting period, during which employees gradually gain the right to exercise their options, influences the valuation. Longer vesting periods may warrant adjustments to account for the extended timeframe over which the options may be exercised.

***b. Forfeiture Rates***

Factoring in forfeiture rates is essential as not all granted options may be exercised. Companies need to estimate the likelihood of employees leaving before options are vested and adjust valuation accordingly.

***c. Expected Option Life***

Determining the expected life of the options is crucial for accurate valuation. It involves assessing historical exercise patterns, employee retention rates, and other relevant factors.

***d. Dividend Payments***

Companies paying dividends must consider their impact on ESOP valuation. The Black-Scholes model typically adjusts for expected dividend payments during the option's life.

For the purpose of accounting valuation is required to be carried by Registered Valuer. Under the income-tax valuation of shared issued under ESOP is required to be done by Merchant Bankers

Valuing Employee Stock Options is a multifaceted process that demands a careful blend of financial acumen, regulatory awareness, and a nuanced understanding of the company's dynamics. As ESOPs continue to play a pivotal role in talent retention and motivation, a well-executed valuation strategy not only ensures compliance with regulations but also contributes to fostering a positive and transparent relationship between employers and employees. By navigating the complexities of ESOP valuation, companies can optimize the benefits of this powerful incentive tool while mitigating potential risks and uncertainties.

**IV. Slump Sale**

Section 50B of the Income Tax Act, 1961 deals with the taxability of profits arising on transfer of any business. Sub-section (1) of Section 50B provides that "any profits or gains arising from the slump sale" shall be chargeable to income tax as capital gain.

Valuation comes into picture for calculation of Full value of consideration of slump sale which has been provided in Rule 11UAE of the Income tax Rules which says that FVOC will be higher of FMV 1 or FMV 2 where

FMV 1 is the adjusted Net assets as mentioned above for Rule 11UA, and

FMV 2 is the total consideration including cash and non-cash component

**V. INDIRECT TRANSFERS**

Section 9(1)(i) of the Act provides that all income accruing or arising, whether directly or indirectly, through or from any business connection in India, or through or from any property in India, or through or from any asset or source of income in India, or through the

transfer of a capital asset situate in India, shall be subject to tax in India. Explanation to the section clarifies that an asset or a capital asset being any share or interest in a company or entity registered or incorporated outside India shall be deemed to be and shall always be deemed to have been situated in India, if the share or interest derives, directly or indirectly, its value substantially from the assets located in India. Provisions are applicable only if it derives value substantially from the assets (whether tangible or intangible) located in India, if, on the specified date, the value of such assets—

- exceeds the amount of ten crore rupees; and
- represents at least fifty per cent of the value of all the assets owned by the company or entity, as the case may be;

**Valuation Date**

**Valuation is required to be carried on the specified date**[4]

- the date on which the accounting period of the company or, as the case may be, the entity ends preceding the date of transfer of a share or an interest; or
- date of transfer, if the book value of the assets of the company or, as the case may be, the entity on the date of transfer exceeds the book value of the assets as on the date referred in earlier bullet point, by fifteen per cent.

Accounting period means each period of twelve months ending with the 31st day of March. However, in case, a company or an entity considering the provisions of the tax laws of the territory, of which it is a tax resident or reporting to persons holding the share or interest, regularly adopts a period of twelve months ending on a day other than the 31st day of March then such other day shall be the accounting period of the company or the entity.

**Valuation Methodology**

Rule 11UC provides a formula for the computation of income from transfer of a share outside India or interest in a company or an entity which is attributable to assets located in India as A x B/C.

- A = Income from the transfer of a share of, or interest in, the company or the entity computed following the provisions of the Act, as if, such share or interest is located in India
- B = Fair Market Value of assets located in India as on the specified date, from which the share or interest referred to in A derives its value substantially, computed following rule 11UB;
- C = Fair Market Value of all the assets of the company or the entity as on the specified date, computed following rule 11UB:

**Fair Market Value**

As per Section 2(22B) of the Income-tax Act 1961 "fair market value", concerning a capital asset, means—

- the price that the capital asset would ordinarily fetch on sale in the open market on the relevant date; and

4. Income-Tax Act Section 9(1)(i) Explanation 6 (d)

- where the price referred is not ascertainable, such price as may be determined as per the rules made under this Act

As per US Treasury Regulation, the fair market value means "the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or to sell and both having reasonable knowledge of relevant facts."

Fair market value for tax purposes also assumes a hypothetical willing buyer and a hypothetical willing seller. This is in contrast to investment value, which identifies a particular buyer or seller and the attributes that buyer or seller brings to a transaction. Fair market value also assumes an arm's-length deal and that the buyer and seller are able and willing. This is not the same as the definition of market value, an often-used real estate term.

The International Glossary of Business Valuation Terms the fair market value reads: "The price, expressed in terms of cash equivalents, at which property would change hands between a hypothetical willing and able buyer and a hypothetical willing and able seller, acting at arms-length in an open and unrestricted market, where neither is under compulsion to buy or sell and when both have a reasonable knowledge of the relevant facts."

## VALUATION OF DIFFERENT ASSETS OF THE COMPANY

### (i) SHARES IN LISTED INDIAN COMPANY

Where the asset is a share of an Indian company listed on a recognised stock exchange on the specified date, the fair market value of the share shall be the observable price of such share on the stock exchange. However in case, the shareholding directly or indirectly confers any right of management or control in relation to the aforesaid company, the fair market value of the share shall be determined as per the following formula

Fair market value = (A+B)/C[5]

- A = the market capitalisation of the company based on the observable price of its shares quoted on the recognised stock exchange
- B = the book value of liabilities of the company as on the specified date;
- C = the total number of outstanding shares

If on the specified date, the share is listed on more than one recognised stock exchange, the observable price of the share shall be computed with reference to the recognised stock exchange which records the highest volume of trading in the share during the period considered for determining the price.

Right of management or control shall include the right to appoint a majority of the directors or to control the management or policy decision exercisable by a person or persons acting individually or in concert, directly or indirectly, including by virtue of shareholding or management rights or shareholders agreements or voting agreements or in any other manner

The observable price shall be the higher of the following:—

- the average of the weekly high and low of the closing prices of the shares quoted on the said stock exchange during the six months preceding the specified date; or

5. Income-tax Rule 11UB(2)

- the average of the weekly high and low of the closing price of the shares quoted on the said stock exchange during the two weeks preceding the specified date;

This is similar that what is specified in Regulation 164 of SEBI (Issue of Capital and Disclosure Requirements) Regulations 2018

### (ii) SHARES IN UNLISTED INDIAN COMPANY

**Valuation methodology**

Where the asset is a share of an Indian company not listed on a recognised stock exchange on the specified date, the fair market value[6] of the share shall be determined on such date as per any internationally accepted valuation methodology for valuation of shares on arm's length basis as increased by the liability, if any, considered in such determination.

As per Section 92F(ii) relevant to transfer pricing "arm's length price" means a price which is applied or proposed to be applied in a transaction between persons other than associated enterprises, in uncontrolled conditions.

The arm's length principle is the condition or the fact that the parties of a transaction are independent and on an equal footing.

**Valuation to be carried by**

The FMV on such date shall be determined by a merchant banker or an accountant

### (iii) INTEREST IN A PARTNERSHIP FIRM OR AN ASSOCIATION OF PERSONS[7]

- the value on the specified date of such partnership firm or Limited Liability Partnership or association of persons, shall be determined by a merchant banker or a chartered accountant and who holds a valid certificate of practice (as per the provision s of the Chartered Accountants Act, 1949) following any internationally accepted valuation methodology as increased by the liability, if any, considered in such determination.

- the portion of the value computed above is equal to the amount of its capital shall be allocated among its partners or members in the proportion in which capital has been contributed by them and the residue of the value shall be allocated among the partners or members as per the agreement of partnership firm or association of persons for distribution of assets in the event of dissolution of the firm or association, or, in the absence of any such agreement, in the proportion in which the partners or members are entitled to share profits and the total of the amount so allocated to a partner or member shall be treated as the fair market value of the interest of that partner or member in the firm/LLP or the association of persons, as the case may be.

6. Income-tax Rule 11UB(3)
7. Income-tax Rule 11UB(4)

**Valuation to be carried by**

Valuation shall be determined by a merchant banker or a accountant

**(iv) Other Assets[8]**

The fair market value of the asset other than Shares in a listed or unlisted Indian company or share in partnership firm/LLP or AOP as referred earlier shall be the price it would fetch if sold in the open market on the specified date as increased by the liability, if any, considered in such determination.

The price it would fetch if sold in the open market means – is the price an asset would fetch in the marketplace or the value that the investment community gives to particular equity or business.

Valuation to be carried by

as determined by a merchant banker or accountant

**(v) The fair market value of all the assets of a foreign company or an entity**

The fair market value of all the assets of a foreign company or an entity shall be determined as under:

***a) Unconnected parties***

The transfer of a share of, or interest in, the foreign company or entity is between the persons who are not connected, persons-

The fair market value of all the assets owned by the foreign company or the entity as on the specified date, for such transfer, shall be determined as per the formula:

The fair market value of all assets = A+B[9]

- A = Market capitalisation of the foreign company or entity computed based on the full value of consideration for the transfer of the share or interest
- B = Book value of the liabilities of the company or the entity as on the specified date as certified by a merchant banker or an accountant

Connected person means any person who is connected directly or indirectly to another person and includes-

- any relative of the person, if such person is an individual;
- any director of the company or any relative of such director, if the person is a company;
- any partner or member of a firm or association of persons or body of individuals or any relative of such partner or member, if the person is a firm or association of persons or body of individuals;
- any member of the Hindu undivided family or any relative of such member, if the person is a Hindu undivided family;
- any individual who has a substantial interest in the business of the person or any relative of such individual;
- a company, firm or an association of persons or a body of individuals, whether incorporated or not, or a Hindu undivided family having a substantial

8. Income-tax Rule 11UB(5)
9. Income-tax Rule 11UB(6)(i)

interest in the business of the person or any director, partner, or member of the company, firm or association of persons or body of individuals or family, or any relative of such director, partner or member;

- a company, firm or association of persons or body of individuals, whether incorporated or not, or a Hindu undivided family, whose director, partner, or member has a substantial interest in the business of the person, or family or any relative of such director, partner or member;
- any other person who carries on a business, if
  - o the person is an individual, or any relative of such person, has a substantial interest in the business of that other person; or
  - o the person is a company, firm, association of persons, body of individuals, whether incorporated or not, or a Hindu undivided family, or any director, partner or member of such company, firm or association of persons or body of individuals or family, or any relative of such director, partner or member, has a substantial interest in the business of that other person;

Market capitalization refers to the total market value of a company's outstanding shares of stock. It is calculated by multiplying the total number of a company's outstanding shares by the current market price of one share. However, a current set of provisions are silent as to what treatment to be provided to preference shares.

***b) In any other case:***

***i) Shares of a foreign company are listed:***

The share of the foreign company or entity is listed on a stock exchange on the specified date, the fair market value of all the assets owned by the foreign company or the entity shall be determined as per formula:

The fair market value of all the assets = A + B[10]

- A = Market capitalisation of the foreign company or entity computed based on the observable price of the share on the stock exchange where the share of the foreign company or the entity is listed
- B = book value of the liabilities of the company or the entity as on the specified date

Where on the specified date, the share is listed on more than one stock exchange, the observable price in the aforesaid formula shall be in respect of the stock exchange which records the highest volume of trading in the share during the period considered for determining the price

***ii) Shares of a unlisted foreign company:***

The share in the foreign company or entity is not listed on a stock exchange on the specified date, the value of all the assets owned by the foreign company or the entity shall be determined as per formula:

The fair market value of all the assets = A + B[11]

10. Income-tax Rule 11UB(6)(ii)(a)

11, Income-tax Rule 11UB(6)(ii)(b)

- A = fair market value of the foreign company or the entity as on the specified date as determined by a merchant banker or an accountant as per the internationally accepted valuation methodology
- B = value of liabilities of the company or the entity if any, considered for the determination of fair market value in A

Usually, enterprise value is determined considering debt. Hence in such scenario value of such debt may not be required to be added.

**Accountant means**

Accountant means a chartered accountant who holds a valid certificate of practice (as per the provision s of the Chartered Accountants Act, 1949) and to determine the fair market value of all the assets of a foreign company or an entity includes any valuer recognised for undertaking similar valuation by the Government of the country where the foreign company or the entity is registered or incorporated or any of its agencies, who fulfils the following conditions

- if he is a member or partner in any entity engaged in rendering accountancy or valuation services then,—
  - (i) the entity or its affiliates has a presence in more than two countries; and
  - (ii) the annual receipt of the entity in the year preceding the year in which valuation is undertaken exceeds ten crore rupees;
- if he is pursuing the profession of accountancy individually or is a valuer then,—
  - (i) his annual receipt in the year preceding the year in which valuation is undertaken, from the exercise of the profession, exceeds one crore rupees; and
  - (ii) he has professional experience of not less than ten years.

**Exchange Rate**

The rate of exchange for the calculation in foreign currency, of the value of assets located in India and expressed in rupees shall be the telegraphic transfer buying rate of such currency as on the specified date as adopted by the State Bank of India constituted under the State Bank of India Act, 1955 for buying such currency, having regard to the guidelines specified from time to time by the Reserve Bank of India for buying such currency, where such currency is made available to that bank through a telegraphic transfer.

***C] Foreign Exchange management Act***

FEMA regulations cover various types of securities, including shares, debentures, bonds, and other instruments. The valuation principles apply to both listed and unlisted securities.

In practice, the expression "internationally accepted pricing methodology" primarily turns to the use of the Discounted Cash Flow method (DCF). In many cases, if there is a need to apply any other internationally accepted pricing methodology other than Discounted Cash Flow Method (DCF) then the background needs to be documented.

Valuations triggers in two scenarios:

a. Issue or transfer of equity shares or compulsory convertible instruments of an Indian company is taking place between a resident company and a non-resident company.

b. When an Indian company or resident acquires or transfers, equity shares in an overseas company.

### Methodologies

In the case of FDI valuation, the fair valuation of shares on an arm's-length basis has to be done by any internationally accepted methodology. Regulations has not mentioned which internationally recognized methodology shall be used so a valuer has to choose a suitable methodology in case of FDI valuations on its own depending on a case-to-case basis.

Commonly used methods include:

a. ***Market Price:*** The market price prevailing on the recognized stock exchanges for listed securities is often considered as the fair value.

b. ***Fair Value:*** For unlisted securities or those not actively traded, the fair value is determined based on internationally accepted valuation methodologies. This may include the discounted cash flow (DCF) method, comparable company analysis (CCA), or any other method recognized by global financial standards.

Foreign Exchange Management (Overseas Investment) Directions, 2022 provides that the valuation in accordance with pricing guidelines, wherever applicable, shall be done upfront. It also provides that with respect to the documents to be taken by the AD bank, they shall be guided by their board approved policy, which may, inter alia, provide for taking into consideration the valuation as per any internationally accepted pricing methodology for valuation. The AD bank shall put in place a board approved policy within two months from the date of these directions i.e. 22 August 2022. However till date nothing is available in the public domain. It is observed that AD Banks are following erstwhile regulation, only a SEBI (Securities and Exchange of India) registered Merchant Banker (Cat-1) can do the valuation if the transaction exceeds USD 5 Million or the transaction pertains to the swap of shares and valuation by a Chartered Accountants in any other cases. Diminution in value of more than USD 10M or exceeds 20% of total Overseas Investment is to be certified by Registered Valuer as per Companies Act or CPA/Registered valuer in host country

Valuation of securities under the Foreign Exchange Management Act (FEMA) in India is a crucial aspect, especially when there is a foreign investment or transfer of securities involving residents and non-residents. FEMA regulations govern these transactions, and adherence to the prescribed valuation methods is essential to ensure compliance.

### Insolvancy and Bankrupcy Code

IBC required valuation to be carried by registered valuaer under following regulation:

- IBC Section 59(3)(b)(ii) Voluntary liquidation of corporate bodies (Asset Valuation Report).
- IBC Section 46(2) The appropriate duration for avoidable transactions (Independent Expert for assessing the evidential value if the transaction.
- IBBI CIRP Regulation 27 read with regulation 35 to determine fair value and liquidation value.
- IBBI Liquidation process Regulation 35 Valuation of assets intended to be sold.
- IBBI Liquidation process Regulation 3(1)(b)(ii) – valuation of assets before Initiation of liquidation.
- IBBI Fast track CIRP Regulation 26 Determination of Fair value and liquidation value

**Valuation of securities held by commercial banks**

Recently, the Reserve Bank of India (RBI) released updated guidelines governing the classification, valuation, and management of investment portfolios for commercial banks. Aligned with international standards and best practices, the revised 'Reserve Bank of India (Classification, Valuation and Operation of Investment Portfolio of Commercial Banks) Directions, 2023' will come into effect on April 1, 2024, applying to all Commercial Banks with the exception of Regional Rural Banks.

The revised directions introduce a principle-based classification system for investment portfolios. Under the new norms, banks are mandated to classify their entire investment portfolio into three categories: Held to Maturity (HTM), Available for Sale (AFS), and Fair Value through Profit and Loss (FVTPL). The RBI has included fair valuation requirements along with accounting treatment for gain/loss ensuring that investment portfolios are assessed accurately, reflecting their current market values. All investments now shall be measured at fair value on initial recognition. Fair value measurement of investments is based on a hierarchy of Level 1, Level 2, and Level 3 inputs.

**Valuation of complex convertible instruments Preference Shares/Debentures:**

Convertible preference shares represent a unique financial instrument that combines features of both debt and equity. Valuing these instruments requires a nuanced approach, considering the dual nature of their characteristics. Here are key points to consider in the valuation of convertible preference shares:

1. ***Face Value and Dividend Yield:***
   - Begin by understanding the face value of the preference shares and the fixed dividend yield they carry. This fixed income component is a critical factor in the valuation process.

2. ***Conversion Premium:***
   - Convertible preference shares typically carry a conversion premium, which is the amount by which the conversion price exceeds the current market price of the common shares. The premium reflects the additional value investors place on the option to convert.

3. ***Conversion Ratio:***
   - The conversion ratio is the number of equity shares that can be obtained by converting one preference share. It establishes the relationship between the preference shares and the potential equity shares upon conversion.

4. ***Market Price of Common Shares:***
   - Since the conversion feature provides an avenue for preference shareholders to participate in the equity upside, the market price of common shares becomes a crucial input in the valuation model.

5. ***Discount Rate:***
   - Apply an appropriate discount rate to the future cash flows, considering the risk profile of the company and the prevailing market conditions. This rate accounts for the time value of money and the risk associated with the investment.

6. ***Option Pricing Models:***
   - Employ option pricing models, such as the Black-Scholes model, to value

the conversion feature. These models consider factors like the current stock price, exercise price, time to maturity, and volatility.

7. ***Earnings and Cash Flow:***

- Evaluate the company's historical and projected earnings and cash flows. The ability of the company to generate profits and cash is a fundamental determinant of the value of both the preference shares and the potential equity shares upon conversion.

8. ***Market Conditions:***

- Consider current market conditions, industry trends, and the economic outlook. Changes in market conditions can impact the perceived value of the conversion feature.

9. ***Redemption Terms:***

- Take into account any redemption terms associated with the convertible preference shares, as these terms may influence the valuation, particularly if the conversion option is not exercised.

10. ***Discounted Cash Flow (DCF) Analysis:***

- Perform a discounted cash flow analysis, incorporating the cash flows from both the fixed dividends and the potential equity upside upon conversion. This holistic approach accounts for the time value of money and the dual nature of the investment.

11. ***Liquidation Preference:***

- If the preference shares have a liquidation preference, understand the terms and conditions associated with it. This can impact the valuation in the event of a liquidation event.

Valuation of convertible preference shares requires a comprehensive analysis that takes into consideration both the fixed income component and the equity conversion option. By carefully assessing these various factors, investors and issuers can arrive at a reasonable and informed valuation for convertible preference shares. More or less similar steps are required to value compulsorily convertible debentures also.

**Epilogue**

While numbers may crunch and formulas may swirl, at the heart of valuation lies a fundamental truth: value is ultimately in the eyes of the beholder. It's a tapestry woven from tangible assets, intangible potential, and the ever-shifting tides of market sentiment The true worth of any endeavor often lies not just in a calculated figure, but in the stories it whispers and the dreams it inspires. As technology evolves and global dynamics shift, the landscape of valuation continues to transform. Artificial intelligence and big data are reshaping traditional methodologies, while emerging concepts like ESG (environmental, social, and governance) considerations are taking center stage. By staying adaptable and embracing these cutting-edge frontiers, we can ensure that the art of valuation remains not just a tool for measuring the present, but a compass guiding us towards a more sustainable and equitable future.

SS-IV-90

# DIRECT TAXES

## Supreme Court

Keshav B. Bhujle
Advocate

**1** ***Bikram Singh vs. Principal CIT; [2023] 458 ITR 684 (SC): Dated 29/08/2023:***

**Appeal to High Court — Substantial question of law — Procedure to be adopted by High Court — Court must formulate question and admit appeal, hear parties and dispose of appeal depending on whether question to be answered for or against either party or no such question of law arises — High Court admitting appeal without formulating substantial question of law and hearing appeal on merits and reserving judgment — Question of law thereafter framed and appeal allowed — Procedure not in consonance with law: S. 260A of ITA 1961: A. Y. 2011-12**

In this appeal, the main grievance was as regards the manner of the disposal of the appeal by the High Court. The Supreme Court held as under:

"i) The main grievance of the appellant-assessee is with regard to the manner of disposal of the appeal filed by the respondent-Revenue, by the High Court. In this regard our attention was drawn to the impugned order to contend that the said appeal was heard finally by the High Court without initially formulating a substantial question of law as required under section 260A of the Act. He drew our attention to paragraph "2" of the said order to submit that the "question of law" which had been raised was not at a time prior to the hearing of the matter on merits in the sense that there was no notice to the assessee with regard to the substantial question of law which was actually raised in the High Court and in the absence of raising any substantial question of law, arguments were heard on merits and the respondent's appeal was allowed.

ii) An appeal before the High Court u/s. 260A of the Income-tax Act, 1961 is maintainable only on a substantial question of law (not a question of fact or only a question of law). The High Court when entertaining such an appeal must formulate that question and admit the appeal; thereafter, on the question so formulated the respondent must also be heard and consequently the matter must be disposed of depending on whether the substantial question of law requires to be answered for or against either of the parties or no such question of law would arise. The High Court has also the power to formulate a fresh

question of law if it so arises on hearing counsel for the respective parties in the event such a substantial question of law would arise and if the High Court is satisfied the case involves such a question. Further, under sub-section (7) of section 260A the provisions of the Code of Civil Procedure, 1908 shall, as far as may be, apply in the case of appeals under this section. Section 100 read with rule 1 of Order XLII of the Schedule to the Code which applies to second appeals would apply, wherein, the formulation of a substantial question of law when the matter is entertained and admitted would be required, otherwise the High Court has the power to dismiss such a second appeal on the ground that no such substantial question of law arises in the appeal.

iii) Issuance of notice prior to admission without framing any substantial question of law is not contemplated under section 260A. The High Court has either to admit or not admit the appeal. If the High Court admits the appeal then a substantial question of law has to be framed and the respondent put on notice on such substantial question of law. On the contrary, if the High Court is of the view that no substantial question of law arises, the appeal has to be dismissed.

iv) The High Court did not formulate any substantial question of law at the time of admitting the appeal, rather the appeal was heard on the merits and without formulating the substantial question of law the appeal was reserved for judgment. During the course of preparation of the judgment, the question of law was framed stated to be a "question of law" and the matter was then admitted and at the same time considered on the merits.

v) We find that the procedure adopted by the High Court in the instant case is not in consonance with what is contemplated under section 260A of the Act and hence, on that short ground alone the impugned judgment is set aside. The matter is remanded to the High Court for reconsideration of the appeal filed by the respondent-Revenue having regard to the essentials of section 260A and in accordance with law. All contentions on the merits of the matter are left open to be urged before the High Court."

---

## 2 ***Johnson G. Oommen vs. CIT; [2023] 459 ITR 150 (SC): Dated 14/09/2023:***

**Export — Special deduction U/s. 80HHC(3) of ITA 1961 — Change of law — Benefits extended in respect of duty drawback credit and duty entitlement pass book scheme — Conditions precedent for special deduction brought with retrospective effect — Rectification of assessments for prior years in light of amendment — Not sustainable: Ss. 80HHC(3) and 154 of ITA 1961: A. Ys. 1999-2000 and 2000-01**

The assessees were cashew exporters who had claimed deduction of income from export of cashew kernels u/s. 80HHC(3) of the Income-tax Act, 1961. The Taxation Laws (Second Amendment) Act, 2005 introduced two provisos to section 80HHC with retrospective effect from April 1, 1992, laying down

ML-176

conditions for the grant of deduction : (a) the assessee had an option to choose either the duty drawback or the Duty Entitlement Pass Book Scheme; and (b) the rate of drawback credit attributable to the customs duty was higher than the rate of credit allowable under the Duty Entitlement Pass Book Scheme. The assessments in the case of the assessee for the A. Ys. 1999-2000 and 2000-01 were rectified u/s. 154 to make the assessments in the context of grant of relief u/s. 80HHC consistent with the amendments to the provisos with retrospective effect.

The Commissioner (Appeals) rejected the challenge against the rectification orders but the Tribunal allowed the appeals holding that the assessments could not be rectified based on retrospective amendment.

The High Court held that the power of rectification u/s. 154 of the Act was rightly exercised by the Assessing Officer and consequently remanded the matters to the Tribunal for reconsideration of the appeals on other grounds.

The Supreme Court allowed the assessee's appeals and held as under:

> "Having regard to the fact that the court in ***UOI vs. Paliwal Overseas Pvt. Ltd. [2016] 16 SCC 697*** had accepted the judgment of the High Court in that case except to the extent that the twin conditions u/s. 80HHC(3) quashed by the High Court would apply to both categories of exporters having a turnover above Rs. 10 crores and those having a turnover below Rs. 10 crores and sustaining the judgment of the High Court in all other respects, the direction for remand after the judgment of the court would be otiose and wholly unnecessary. The issue having been settled, the remand was redundant. Consequently, the original orders of assessment, i. e., prior to rectification were restored."

"Books are infinite in number and time is short. The secret of knowledge is to take what is essential. Take that and try to live up to it."

— *Swami Vivekananda*

"Prayer is not asking. It is a longing of the soul. It is daily admission of one's weakness. It is better in prayer to have a heart without words than words without a heart."

— *Mahatma Gandhi*

# DIRECT TAXES
## High Court

Jitendra Singh
Advocate

Radha Halbe
Advocate

Harsh Shah
Advocate

### 1 *Anish Modi vs. Union of India [2023] 157 taxmann.com 597 (Bombay)*

**Principal Officer - Meaning of - Section 2(35) of the Income Tax Act, 1961 - No notice as contemplated under section 2(35) had been served upon assessee, who was an independent, non-executive, and nominee director on Board of company before initiating prosecution against him under sections 276B and 278B of the Act - prosecution proceedings initiated against assessee is bad in law**

The assessee before the Hon'ble Bombay High Court was an independent, non-executive, and nominee director on the Board of M/s. S. Kumar Nationwide Limited ('Company') from 27 June 2007 to 12 November 2011. For the financial year 2008-09, the company failed to deposit the TDS amounting to Rs. 2,98,29,252/- to the credit of the Central Government within the prescribed period. The company deposited the TDS amount in September 2010.

The Income Tax Department initiated prosecution proceedings against the company and the assessee as one of the accused persons invoking the provisions of section 276B of the Act, which provides that if any person fails to deposit the tax deducted by him with the Central Government within the stipulated period, an offence is deemed to have been committed under the Act.

The assessee came to know about the Criminal Case and the orders passed thereunder only on 5th September 2022, when he has received a copy of the summons dated 3 August 2022. The assessee challenged the prosecution proceedings initiated against him before the Hon'ble Bombay High Court, by way of Criminal Writ Petition, seeking quashing of the criminal complaint and the orders passed in pursuance of the same.

Hon'ble Bombay High Court was pleased to allow the Writ Petition filed by the assessee and quashed the prosecution proceedings initiated against him by observing that before issuing the process, the learned Magistrate did not take into consideration the relevant provisions of the I.T. Act and determine whether the mandatory notice under section 2(35)(b) of the Act was delivered to the accused or not. Needless to state that an order of issuance of process is not an empty formality and requires the Magistrate to apply his mind before issuing the process. Passing orders of issuance of a process without appreciating the statutory provisions and cautiously examining the material on record may put the wheels of criminal law in motion and summon an innocent individual to stand trial. Such orders are liable to be quashed and set aside.

ML-178

## 2 *Pr. CIT vs. H.P. Housing & Urban Development Authority [2023] 157 taxmann.com 598 (Himachal Pradesh)*

**Deductions – Section 80IB(1) of the Income Tax Act, 1961 - Profits and gains from industrial undertakings other than infrastructural development undertakings (Housing projects) – belated filing of return due to delay in audit – eligibility to claim the deduction not doubted - denying the benefit of deduction not justified. (Section 80AC)**

The assessee filed its return belatedly under section 139(4) for the relevant assessment year 2006-07. Subsequently, the assessee filed revised return wherein for the first time it claimed deduction under section 80IB(10) of the Act. The AO disallowed the claim made under section 80IB(10) on the ground that the assessee has not filed its return within the due date specified under section 139(1) and therefore, such claim is not allowable as per the provisions of section 80AC of the Act. On appeal, the first appellate authority held that the project is eligible for deduction However, as the assessee cannot revise its return under section 139(5) which is already filed belatedly under section 139(4) and accordingly held that claim for deduction under section 80IB(10) is not valid.

On further appeal to the ITAT, the Tribunal held that claim for deduction under section 80IB(10) cannot be made based on a non-est ITR i.e., revised ITR in which claim was made under section 80IB(10) of the Act. However, on merits, the Tribunal held that as the project is otherwise eligible for deduction under section 80IB(10) of the Act; such deduction should not be denied merely for non filing of ITR within due date.

The department being aggrieved by the above decision of the Appellate Tribunal filed an appeal before the Hon'ble Himachal Pradesh High Court.

Hon'ble High Court was pleased to dismiss the appeal of the department by observing that if the assessee is otherwise entitled to deduction under section 80-IB(10), but due to its ignorance or for some other reasons could not claim the same in the return of income, but has raised its claim before the Appellate authority, then the Appellate Authority should have looked into the same. The Assessee cannot be burdened with taxes which it otherwise is not liable to pay under the law. A duty is cast upon the Income Tax Authorities to charge legitimate taxes from the tax payers. Revenue cannot punish the tax payers for the bonafide mistakes.

## 3 *Pandian Anbalagan vs. ITO [2023] 156 taxmann.com 402 (Madras)*

**Reassessment – Section 148 of the Income Tax Act, 1961 – notice issued in the name of defunct company – invalid.**

The assessee before the Hon'ble Madras High Court is the Director of the Speed & Safe Freight Systems India Private Limited and the said Company was struck-off from the official register of companies with effect from 29.10.2019. The assessee received a notice under section 148 of the Act on 31.03.2021 for reopening of assessment for the assessment year 2015-16. The assessee challenged the same before the Hon'ble Madars High Court under Article 226 of the Constitution of India.

Hon'ble High Court was pleased to quash the notice issued under section 148 of the Act and held that the impugned notice as well as order could not be passed against a struck-off company, as it would be construed as passing of order against a dead person. Therefore, in a case where name of company had been struck-off, right course available for the Income Tax Department would be to approach NCLT for revival of company as only after revival of the company, it would be open for revenue to initiate reassessment proceedings.

ML-179

# DIRECT TAXES
## Tribunal

CA Nikhil Mutha CA Viraj Mehta CA Kinjal Bhuta

**1** ***M/s. Amala Jyothi Vidya Kendra Trust vs. PCIT [ITA No. 458/Bang/2023 dt. 01.12.2023 (Bang) (Trib.) (AY: 2021-22)***

**Sec. 12AB – PCIT cancelled the trust's registration – invoked provisions of section 12AB(4)(ii) retrospectively from AY: 2021-22 – Held that no cancellation of registration under amended provisions of 12AB(4)(ii) retrospectively**

**Facts**

The assessee a charitable trust was registered u/s. 12AA of the Act by DIT(E). The trust applied for registration under the amended provisions of the Act to continue its earlier registration. The DIT(CPC) granted the registration from AY: 2022-23 until AY: 2026-27. A search was conducted in the office premises of the assessee trust and various incriminating materials were found which indicated that the chairman, trustee, and secretary of the assessee trust were utilizing the trust's funds for their personal benefit. Consequently, the AO initiated assessment proceedings for the AY: 2021-22. The AO sent a reference under the second proviso to Section 143(3) of the Act for AY: 2021-22 to PCIT, requesting the cancellation of the registration granted. After issuing a show cause notice and considering the assessee's reply, the PCIT cancelled the registration granted u/s. 12AA/12AB of the Act to the assessee w.ef. AY: 2020-21 and onwards u/s. 12AB(4) of the Act. Against this order of PCIT, the assessee has preferred an appeal before the Hon'ble ITAT.

**Held**

Before Hon'ble ITAT, the AR argued that the PCIT cancelled the registration by invoking the provisions of Section 12AB(4)(ii) of the Act for alleged violations outlined in Explanation (a) to (e) below the provisions of Section 12AB(4)(ii) of the Act, without acknowledging that these provisions were introduced in vide Finance Act 2022 w.e.f. 01.04.2022. The AR submitted that the provisions were applicable from AY: 2022-23 and do not apply to a default alleged to have occurred in AY: 2021-22 and hence, the cancellation of registration is bad in law. It was submitted that cancellation of registration is penal in nature and the law should apply with reference to the year of default and applying the provisions to an earlier year is incorrect. On the contrary, the DR submitted since the registration was cancelled vide order dated 12.05.2023, the PCIT did not commit any error in applying

ML-180

the provisions of Section 12AB as amended by the Finance Act 2022.

The Hon'ble ITAT after referencing relevant sections and various case laws, held that the law as stated in the AY: 2021-22 is to be applied and not the law as stood in the AY: 2022-23. It was also held that no retrospective cancellation could be made u/s. 12AB(4)(ii) of the Act, without a specific mention of the amended provisions operating retrospectively. The Hon'ble ITAT also relied on the decision of Hon'ble Mad HC in case of ***Auro Lab Ltd vs. ITO*** (411 ITR 308) where in it was held that without a specific mention of amended provisions to operate retrospectively, the cancellation cannot operate from a past date. Thus, the assessee's appeal was allowed and the cancellation of registration with retrospective effect from AY: 2021-22 was held as bad in law.

## 2 *V. M. Star vs. ACIT [ITA No. 2516-2519/Mum/2023 dt. 13.12.2023] (AY: 11-12 to 14-15)*

**Sec. 68 – Bogus Purchase – Estimation of Gross Profit sustained – If GP% on alleged bogus purchase is more than GP% on genuine purchase – No further addition can be made**

**Facts**

Revenue carried out search and seizure action in the hands of a person named Shri Bhanwarlal Jain and his group of companies on 03.10.2013. During the course of search, it was found that the above said person and his group companies were providing accommodation entries. Assessee had purchased diamonds from group concerns of Shri Bhanwarlal Jain. Hence, the Assessing Officer took the view that the assessee has taken accommodation bills for purchases. During assessment, assessee contended that it has actually purchased the diamonds from the concerns belonging to Shri Bhanwarlal Jain and exported them. The assessee produced stock details in order to show that the diamonds purchased from the above said group was exported/sold. However, the Assessing Officer did not agree with the submissions made by the assessee and estimated 3% of the purchased in 3 years and disallowed 100% for 1 year. CIT(A) after considering the submissions and judicial precedents enhanced the addition to 12.5% for 3 years and reduced addition to 12.5% from 100% for 1 year. Being aggrieved, cross appeals were filed before Hon'ble ITAT.

**Held**

Hon'ble ITAT held that there is no dispute with regard to the fact that the assessee has reconciled the purchases with corresponding sales. It is trite in law that when sales have been accepted, then it is necessary to deduct corresponding purchase cost in order to arrive at the profit. The sales have been accepted and hence corresponding purchases have to be deducted. Assessee has contented that rate of profit earned in the alleged bogus purchases was more than the rate of profit declared in the genuine purchases. Hon'ble ITAT has directed the AO to verify the issue in accordance with the decision rendered in the case of M/s Mohammad Haji Adam & Co (Income tax Appeal No. 1004 of 2016 dated February 11 2019) by Hon'ble Bombay High Court, i.e., the addition should be limited to the extent of bringing the G.P rate on alleged bogus purchases at the same rate

of other genuine purchases. Accordingly, it was held by Hon'ble ITAT that if the rate of gross profit declared in the alleged bogus purchases is more than the rate of gross profit declared in the genuine purchases, then no addition can be sustained.

## 3 ***Serco India Pvt Ltd vs. ACIT (ITA No.3392/ Delhi/ 2019 dated 8/11/2023) (Delhi ITAT) (AY: 2013-14)***

**Section 68 - Addition on account of increase in Trade payables/Creditors - No material on record to justify the addition since the nature of outstanding is explained with details of subsequent payments**

**Facts**

Serco India Private Limited was a subsidiary of Serco Group PLC, UK, incorporated in India on 27-02-2006. The company was established as a captive service centre. In the year under consideration, the Assessee only rendered management consultancy services to its Associated Enterprise (AEs). The assessee company was compensated for the services rendered to AEs on a cost-plus mark-up of 15%.

The assessee company filed its return of income for Assessment Year 2013-14 on 29.11.2013 declaring loss of Rs. 5,68,34,642/- which was processed u/s 143(1) of the Income Tax Act, 1961. The losses had occurred since besides providing services to AEs, the Assessee had incurred substantial expenditure in expanding its operations to maintenance of Public Transport (Road and Railways) and for which during the year under consideration, the Assessee had incurred substantial manpower and bidding expenditure.

The Board of Directors of the company in its resolution dated 27th August 2014 decided to close down the operations of the company in the foreseeable future. Thereafter, all the shares of the assessee- company were sold to M/s Travel Time Car Rental Private Limited and M/s Mahalaxmi Automotives Private Limited by Serco Group *vide* Share Purchase Agreement executed on 11- 03-2015.

When the assessment proceedings were taken up by the AO in the year 2016, after receipt of TPO order, the present management was not able to produce books of account and supporting documents before the AO as the same were not available with them. Despite their best efforts to collect the documents from the earlier management, the new management could not obtain the relevant documents from Serco Group UK.

The AO noted that the assessee company has shown closing balance of sundry creditors (trade payables) at Rs. 21,17,67,393/- as against opening balance of Rs. 9,44,48,020/-. Hence, there was a difference of Rs. 11,73,19,373/-. The AO observed that the assessee failed to furnish the details of creditors along with confirmations and therefore, the AO made addition of Rs. 11,73,19,373/- u/s 68 of the Act.

During the appellate proceedings before Ld. CIT(A), the assessee furnished details of sundry creditors (trade payables) outstanding as on 31.03.2013 which included:

(a) Details of subsequent payments against provision for expenses (Rs. 3,22,02,248)

(b) Details of inter-corporate payables (Rs. 17,51,45,528), which relates to part-salary reimbursement of expatriate employees. The Assessee furnished

ML-182

evidence of payment including Form 15CA alongwith copy of relevant bank statement.

The Ld. CIT(A) confirmed the addition u/s. 68 of the Act observing that no supporting evidence to prove the genuineness of credit balance was furnished by the assessee. He further noted that as per the agreement between the assessee and its AEs, the expenses were reclaimed by the assessee on cost plus basis with a markup factor of 15%. In these circumstances, any salary payable to expats was recoverable by the assessee with a markup factor of 15%. There is, therefore, no net liability in the hands of the assessee for payment of salary payable to expats to its AE. Moreover, these creditors on account of company payables have been shown to be accumulating from F.Y. 2010-11 onwards and continued as such in the accounts of the assessee upto the year 2014 and were thereafter claimed to have been settled through and in accordance with the terms of the share purchase agreement dated 11.03.2015. The ld. CIT(A) held that it is highly improbable that no payment was adjusted by the AE against this liability when the assessee raised its bills on cost plus basis.

**Held**

The Hon'ble ITAT held that the addition is not sustainable on account of the following factors: (i) Factually, sundry creditors as on 31.03.2013 of Rs. 21,17,67,393/- were genuine (ii) Legally, no addition can be made u/s 68 of the Act on account of difference in opening balance and closing balance of sundry creditors.

The Hon'ble ITAT observed that the assessee company had entered into a Salary Reimbursement Agreement with Serco UK in January 2010. As per this agreement, for administrative convenience only and at the request of the assessee company, Serco UK agreed to pay to Serco India employees' part of salary in foreign currency on behalf of Serco India. The foreign currency salary paid by Serco UK to assessee's employees on behalf of the assessee was to be reimbursed by the assessee to Serco UK on cost-to-cost basis. The salary reimbursement payable to Serco UK has been shown regularly by the assessee as international transaction between AE in the TP Reports and has been examined by the TPO. Thus, the Hon'ble ITAT held that the observation of the Ld. CIT(A) that the assessee was providing services to its AEs on cost plus mark-up of 15% and there should be no liability in the hands of assessee for salary payable to expats to its AE is not based on proper appreciation of facts of the case. Further, the Hon'ble ITAT noted the fact that the trade payables of GBP 1,923,958 in the case of Serco Limited, UK has been paid in February 2015 by remittance through HSBC Bank and Copy of Form 15CA evidencing such remittance.

Also, as regards Provision for expenses made at the end of the year of Rs. 3,22,02,348/-, the Hon'ble ITAT held that the assessee has been maintaining its books of accounts on accrual basis and therefore, the assessee had to make provisions for expenses accrued during the year. The assessee has furnished details of subsequent payments made mainly in the next quarter up to June 2013 to these parties from the statement of bank account. There is no contrary material on record to suggest that these were non-genuine expenses. The other liabilities of trade payables were also paid in the subsequent financial year.

Hence, on consideration of above-mentioned facts, the Hon'ble ITAT held that no addition is called for u/s. 68 of the Act of Rs. 11,73,19,373/- on account of unexplained increase in sundry creditors in the books of account during the previous year.

The above addition was besides *adhoc* disallowance of operational expenditure made by the AO. The same is not dealt with as a part of this summary and the readers can refer the decision for the same.

## 4 *Kirti Singh vs. ACIT [ITA No. 1067/Del/2023 dt. 07.12.2023 (Del)(Trib.) (AY: 2021-22)*

**Sec. 69A –Addition for jewellery found exceeding the limits prescribed by CBDT instruction – assessee was a high net-worth individual – declared substantial income during the earlier years – addition made were deleted.**

**Facts**

A search was conducted u/s. 132 of the Act at the assessee's premises and certain jewellery was found at the residence and in the locker. During the assessment proceedings, the appellant submitted that the jewellery pertains to the assessee, her husband, two sons, mother-in-law, and two sisters-in-law. The AO in the light of CBDT instruction No. 1916, granted the benefit of allowable limit to different family members except the two sisters-in-law. Consequently, the AO made additions u/s. 69A of the act for the entire jewellery attributable to the two sisters-in-law and the jewellery pertaining to the assessee exceeding the allowable limit, as the assessee failed to furnish bills, vouchers, and the source of purchase of the jewellery. The CIT(A) confirmed the actions of the AO. Against the addition made u/s. 69A of the Act, the assessee has preferred an appeal before the Hon'ble ITAT.

**Held**

Before the Hon'ble ITAT, the AR argued that AO had ignored the customary practices prevalent in Indian society, wherein women often keep their jewellery in their maternal homes for various reasons. The AR further argued that the assessee's sisters-in-law kept a part of their jewellery in the custody of the assessee's family which is not uncommon in Indian families and therefore, there was no justification to ignore the explanation offered in the course of the assessment proceedings. Further, the CBDT instruction no. 1994 does not bar the retention of jewellery above the threshold limit. The assessee holds an affluent status and customs and community practices also allow for the possession of a greater quantity of jewellery. Additionally, both the assessee and her spouse have consistently declared substantial taxable income. Assessee a result, there is no doubt about the assessee's status, and thus retention of high-value jewellery is credible and a valid explanation for holding such jewellery.

The Hon'ble ITAT examined the income tax returns filed for the earlier years and noted that the assessee and their family members are high net worth individuals and thus, holding such jewellery found in the custody of members of their families cannot be treated as abnormal, and consequently unexplained. The Hon'ble ITAT cited para 3 of the CBDT instruction, which states that a

higher quantity of jewellery may be excluded based on the family's status, customs, and practices of the community, particularly for the persons falling into higher income tax brackets. It was held that the assessee had demonstrated the plausibility of holding jewellery exceeding the limits specified by the CBDT instruction. The Hon'ble ITAT relied on various judgments and set aside the order of CIT(A) and directed the AO to delete the additions made u/s. 69A of the Act.

## 5 *Golden Tulip Hospitality Pvt. Ltd. vs. ACIT [ITA No. 264/Asr/2023 dt. 10.11.2023 (Amritsar)(Trib.) (AY: 2014-15)*

**Sec 142(6)—No additions can be made based on time-barred DVO report – impugned additions were deleted.**

**Facts**

A search was conducted u/s. 132 of the Act at the premises of the directors of the appellant company. The AO made an addition of Rs. 1,18,82,100/- u/s. 69A of the Act alleging that assessee had not fully disclosed certain receipts in its books of accounts. The CIT(A) restricted the said additions to the difference between the cost of construction estimated by the DVO and the cost of construction declared by the assessee. Against CIT(A)'s order, the assessee has preferred an appeal before the Hon'ble ITAT.

**Held**

Before the Hon'ble ITAT, the AR argued that the CIAppellant(A) overlooked the fact that the overall difference in the valuation report for all the years taken together was less than 10%. Therefore, it cannot serve as a basis for making the addition, as the valuation report is merely an estimate and should not be relied upon for making an addition. The AR further argued that the DVO conducted the valuation by considering the CPWD rates instead of PWD rates. Additionally, the AR contended that the addition could not be sustained as the DVO report relied upon by the CAppellantT(A) was time-barred u/s. 142(6) of the Act. Conversely, the DR relied on the order of Appellant IT(A).

The Hon'ble ITAT held that the valuation report of DVO is barred by limitation and thus cannot be relied upon for making the addition. It was further held that the addition was made without allowing the benefit of the rate difference between the CPWD and PWD rates. Therefore, the impugned additions were deleted.

## 6 *ITO vs. Aaress Realty Pvt Ltd (ITA No. 794/Mum/2023 dt. 13.12.2023) (AY 13-14)*

**Sec. 143(2) – Assessment Reopened u/s. 148 - Issuing notice u/s. 143(2) is mandatory – No Notice u/s. 143(2) – Assessment shall be Null and Void-Ab-Initio**

**Facts**

Assessee's case was reopened u/s. 147 of the Act for the reason that the information was received from Pr. DIT (Investigation)-1, Mumbai that the assessee was one of the beneficiary of accommodation entries provided by Shri Gautam Jain and others (Surat Diamond Concerns) group in the form of non genuine purchase bills and unsecured loans, etc, pursuant to the search

action carried out in the case of Shri Gautam Jain and group concerns dated 03.10.2013. In Assessment, addition was made on the issue for which reopening was made. CIT (A) considering the facts and submissions allowed the appeal on merits. Being aggrieved, appeal was filed by the revenue. Before ITAT, assessee challenged the validity of assessment on account that no notice u/s 143(2) was issued by filing cross objections.

**Held**

Hon. ITAT held that assessee's allegation that notice u/s. 143(2) was never issued stand substantiated by taking an adverse inference that the Revenue has no records to controvert in spite of several opportunities given. When the assessee has stated that the original return of income be treated as return of income filed in response to notice u/s. 148 of the Act, then the Ld. A.O. is bound to mandatorily issue notice u/s. 143(2) of the Act for assuming jurisdiction for assessing the income of the assessee. Mere recording in the assessment proceeding that notice was served without corroborating it with supporting documentary evidence will not validate the assessment proceeding. ITAT relies on the decision of the Hon'ble Apex Court in the case of ***Hotel Blue Moon [2010] 321 ITR 362 (SC)***, wherein it has been held that non issuance of notice which is mandatory is not a curable defect. The non issuance of notice u/s. 143(2) of the Act which was a mandatory procedure would amount to procedural irregularity making the entire reassessment proceeding to be vitiated and would not be a curable defect u/s. 292BB of the Act. Further reliance on decision of the Hon'ble Jurisdictional High Court in the case of ***CIT vs. Sodder Builder and Developer Pvt. Ltd. [2020] 156 taxmann. com 251 (Bom)*** was made. Accordingly cross objection filed by the assessee was allowed and assessment was held to be null and void ab intio.

---

## 7 ***Tata Sons Pvt Ltd vs. DCIT [ITA No.2362/Mum/2023 dt. 15/12/2023 (Mum) (Trib) (AY 1993-94)***

**Section 244A(1)/(1A) – Interest – Adjustment of refund already granted, Interest to be granted till date of receipt of refund, Additional interest to be granted for delay in passing the Order Giving Effect**

**Facts**

The assessee is the principal investment holding company and promoter of Tata companies. The return of income for AY 1993-94 was filed on 31.12.1993 returning NIL income. The return was subject to assessment / re- assessment and rectification over a period of time. The coordinate bench of the ITAT through orders dated 04.02.2015 and 01.01.2016 gave relief to the assessee. The AO passed an order giving effect (OGE) dated 08.03.2016 granting the refund of Rs. 30,45,62,594 and the assessee received the said refund on 18.08.2022.

The grievance of the assessee with regard to the short credit of interest was on three counts:

(a) Apportionment of refund against interest determined earlier instead of interest as per the OGE

(b) Interest is not granted from the date of passing the OGE till the date of receipt of Order

ML-186

(c) Additional interest under section 244(1A) for delay in passing OGE is not considered

**Held**

- The Hon'ble ITAT relied on the decision in the case of ***Grasim Industries Ltd vs. DCIT (123 taxmann.com 312)***, wherein it has been held that interim refund granted should be first adjusted against the updated interest payable considering the final OGE and thereafter balance amount of interim refund granted should be adjusted towards tax component. This leads to computation of higher interest for subsequent refund tranches. The Hon'ble ITAT also held that it does not tantamount to interest on interest. In light of the said decision, the Hon'ble ITAT directed the AO to consider the working submitted by the Assessee and grant additional refund of interest.

In relation to interest to be granted till date of receipt of refund - - The Hon'ble ITAT granted relief relying on the decisions of Jurisdictional High Court in the case of ***Pfizer Limited (191 ITR 626), Citibank N.A (ITA 6/ 2000)*** and ***KEC International (ITA 1038 of 2000).***

In relation to additional interest under section 244A(1A) of the Act - The ITAT order was passed on 4/02/2015 and 01/01/2016. However, the OGE was passed on 18/08/2022. The provision of section 244(1A) is applicable from 1/06/2016. Hence, there is a delay of 75 months for which the Assessee is entitled for additional interest of 3% pa. under section 244(1A) of the Act. The Hon'ble ITAT relied upon the decision of Bharat Petroleum Corporation Limited (ITA No.5231 to 5233 of 2019). In light of the said decision, the Hon'ble ITAT held that the provisions of sub-section (1A) to section 244A are inserted by the Finance Act, 2016 as a remedial measure to compensate the assessee in cases where there are delays in granting refunds due on account of delay in passing order giving effect to appellate or revisional orders. Hence, the Assessee is entitled for additional interest 244A(1A) of the Act from 1/06/2016 till the date of receipt of refund.

---

**8** ***DCIT vs. M/s Sasan Power Ltd [ITA No. 1923/Mum/2023 dt. 22.12.2023] (AY: 17-18)***

**Sec. 270A – Under Reporting of Income – Excess Depreciation Claimed - *Bona fide* mistake while filing Return of Income – No Penalty to be Levied**

**Facts**

Assessee had filed its return of income dated 31.10.2017 and subsequently filed revised return of income dated 30.03.2018, declaring total loss at Rs. (-)1255,55,66,434/-. During assessment it was found that assessee while computing the income from business had reduced the amount of profit on disposal of assets of Rs. 4,62,00,000/- as being fixed asset and while computing the depreciation it had erroneously not reduced the amount of insurance claim received from the block of assets. Thereby, claiming higher depreciation on fixed assets. Assessee then filed revised working of deprecation during the assessment proceeding after duly reducing the claim of insurance from the block of assets. AO disallowed the excess claim of depreciation and passed the assessment order accordingly. Penalty u/s 270A was also initiated for under reporting of income. CIT(A) deleted the

impugned penalty for the reason that the assessee's claim of excess depreciation was a bona fide mistake and that there was no mens rea on the part of the assessee to suppress any material fact for the purpose of avoiding tax. Being aggrieved with the decision, department has filed appeal before Hon. ITAT.

**Held**

Hon. ITAT held that assessee during the assessment proceeding had given details of the computation of income where the assessee company has reduced the amount on profit of disposal of assets of Rs. 4,62,00,000/- as income from business as it pertained to fixed assets. Assessee has also submitted that it had inadvertently not reduced the amount of insurance claim received by the assessee from the block of assets thereby claiming more depreciation on fixed assets & filed revised working of depreciation with computation of income after duly reducing the claim of insurance received from the block of assets. Assessee is not in an advantageous position to claim higher depreciation as it was adverse for the assessee in subsequent years and that there was no question of reducing the tax liability where the assessee's return of income declared a huge loss. Hon. ITAT concurred with the finding of CIT(A) by relying on Hon'ble Apex Court in the case of ***CIT vs. Reliance Petro Products Pvt. Ltd. (supra)*** where it has held that furnishing inaccurate claim of expenditure would not amount to giving inaccurate particulars of such income. Decision of the Hon'ble Jurisdictional High Court in the case of ***CIT vs. Somany Evergreen Knits Ltd. [2013] 35 taxmann.com 529 (Bom)*** has held that excess claim of depreciation was a *bona fide* mistake on the part of the assessee which attracts no levy of penalty. By virtue of the above, Hon. ITAT deleted the penalty on account that since the error was *bona fide* no penalty can be levied.

**9** ***M/s Sutherland Global Services Inc & Others vs. ACIT/DCIT & Others (ITA No. 27/CHNY/2023 dated 12/12/2024) (Multiple AYs)***

**CBDT Circular 19/2019 – DRP - Directions without DIN/DIN not duly quoted in the Directions - Invalid**

**Facts**

The above decision consists batch of 54 appeals filed by different Assessee's against their respective final assessment orders passed by the Assessing Officer u/s. 143(3) r.w.s 144C(13) of the Act in pursuant to directions of the DRP issued u/s. 144C(5) of the Act.

The assessees' have raised additional ground in light of the CBDT Circular No. 19/2019 dated 14.08.2019 contesting that the order passed by the AO/DRP without a valid computer-generated Document Identification Number ('DIN') and quoted in the body of the order is illegal and non-est and deemed to have never been issued. Multiple Counsels represented the matter from Assessee's side and the Revenue was represented by Additional Solicitor General and the Sr CIT(DR).

**Held**

The Hon'ble ITAT observed that the CBDT has through Circular No. 19/2019 made it compulsory that on and from 01.10.2019, a DIN has to be duly generated/ allotted and quoted in the body of all communication.

The significance of DIN is emphasised besides the above Circular in Press Release dated 14.08.2019 issued by the Ministry of Finance and FAQ issued by the Income-tax Department.

The reason for generation of DIN has been explained in Para 1 of the said Circular. Para 2 of said Circular mandates Income-tax Authorities to generate DIN and duly quote the same in the body of communication to be issued to the assessee or any other person on or after 1st day of October, 2019. As per Para 3 of the said Circular, in exceptional circumstances as mentioned therein, communication may be issued manually but only after recording reasons in writing in the file and with prior written approval of the Chief Commissioner/Director General of income-tax. As per para 4 of the Circular, any communication which is not in conformity with para 2 & 3, shall be treated as invalid and shall be deemed to have never been issued. Therefore, the Hon'ble ITAT held that from the said Circular, it is undoubtedly clear that on and from 01.10.2019, any communication issued without a valid DIN and quoted in the body of the order is invalid and shall be deemed to have never been issued.

To comply with the provisions of Circular, every income-tax authority is required to satisfy the twin conditions i.e., a) allot DIN and b) quote such DIN in the body of the communication. In all these cases, computer-generated DIN has not been quoted in the body of the order. Although in few cases, a handwritten DIN is quoted in the body of the order, but it was explained by the counsels of the assessee's that if you authenticate the document by using said DIN number, the income- tax database shows an error 'no record found for the given document number'. Although, the Department has contended that in a case where DIN has been separately generated and/or communicated, it would be sufficient compliance of the impugned circular, the Hon'ble ITAT was of the view that the requirement of impugned circular is to allot and quote DIN in the body of the communication but not generation and communication of DIN by separate intimation. The Hon'ble ITAT was of the opinion that when a statute describes or requires a thing to be done in a particular manner, it should be done in that manner or not at all. Therefore, Hon'ble ITAT held that any communication issued by the income-tax authority without a valid computer-generated DIN and not duly quoted in the body of such communication is to be treated as invalid and shall be deemed to have never been issued. Accordingly, the said technical issue was allowed in favour of the Assessee holding that orders passed by the DRP/AO is invalid, non-est and shall be deemed to have never been issued. Since appeal was allowed on the technical ground, other grounds raised by the assessee's on merits becomes academic in nature and thus, not adjudicated at this stage.

In arriving at the above conclusion, the Hon'ble ITAT observed/ concluded the following in relation to the arguments raised by the Department:

(a) DRP direction is not merely in the nature of internal communication since as per section 144C(15) of the Act read with Rule 11 & 13 of the DRP Rules, 2009, the Directions are to be served on the assessee and assessee can file rectification, if any.

(b) DRP is an income-tax authority since it is a collegium of three Commissioners

formed under the provisions of section 118 & 119 of the Act. Thus, the Directions issued by the DRP should also comply with the provisions of the aforesaid CBDT Circular.

(c) Subsequent generation of DIN number and handwritten in the body of the order does not satisfy the conditions.

(d) The decisions relied upon by the Revenue were distinguished by the Hon'ble ITAT.

(e) There is no merit in the argument of the Revenue that there is no integration between ITBA portal and DRP module and because of this, DRP is unable to generate DIN numbers when the order was passed.

(f) What is challenged before ITAT is final assessment order, which is passed in pursuant to the directions of the DRP. If there is no valid DRP direction, the assessment order passed by the AO becomes time barred once the order of DRP has been held to be non-est. Thus, present appeals are maintainable.

(g) It is a well settled principle of law that an illegal order would be in operation till it is vacated or set aside by the competent court in appeal. The impugned orders passed by the AO/DRP would be in operation having its own statutory force till it is vacated or set aside in appeal.

"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*

"Your beliefs become your thoughts,
Your thoughts become your words,
Your words become your actions,
Your actions become your habits,
Your habits become your values,
Your values become your destiny."

— *Mahatma Gandhi*

# INTERNATIONAL TAXATION
## Case Law Update

Dr. CA Sunil Moti Lala
*Advocate*

## A. SUPREME COURT

### 1 *CIT(IT) vs. Nagravision S.A [(2023) 157 taxmann.com 458 (SC)]*

**SLP dismissed on ground of delay and merits against order of High Court that income of assessee, a Switzerland based company from supply of CAS and middleware products to Indian customers does not fall under 'royalty' as defined under section 9(1)(vi) and article 12(3) of India-Swiss DTAA and thus, same does not give rise to any income taxable in India**

**Facts**

i. The Hon'ble High Court held that in view of decision of Supreme Court in case of ***Engineering Analysis Centre of Excellence (P.) Ltd. vs. CIT [2021] 124 taxmann.com 42/432 ITR 471***, income of assessee, a Switzerland based company from supply of CAS and middleware products to Indian customers did not fall under 'royalty' as defined under section 9(1)(vi) and article 12(3) of India-Swiss DTAA and thus, the same did not give rise to any income taxable in India.

ii. Aggrieved, the Revenue filed SLP before the Hon'ble Apex Court with delay of 325 days.

**Decision**

i. The Special Leave Petition was dismissed both on the ground of delay as well as on merits.

## B. HIGH COURT

### 2 *Godaddy.com LLC vs. ACIT [(2023) 157 taxmann.com 256 (HC - Delhi)]*

**Fee received by assessee, a domain name registrar, for registration of domain names of third parties, i.e., its customers, could not be treated as royalty**

**Facts**

i. The assessee, a US based company was an accredited registrar for the Internet Corporation for Assigned Names and Numbers (ICANN). It did not have any PE in India

ii. It provided services such as domain name registration, website design, and web hosting and charged a fee from its customers for facilitating domain name

registration, which was shared, three ways i.e a part of the fee received from the customers was kept by the assessee and a portion of the fee was shared with ICANN and the registry.

iii. The domain name's owner was the customer who sought domain name registration and the customer could, at his option, dissolve his engagement with the assessee and move to another registrar, having a back-to-back arrangement with ICANN and the registry appointed by it [The customer would not have been able to engage with another Registrar had the assessee been the domain name's owner].

iv. The AO by way of draft assessment order proposed an addition concerning the income of the assessee received against domain name registration services offered to its customers by construing the same as royalty. The said order was upheld by the DRP and the Hon'ble Tribunal.

v. Aggrieved, the assessee filed an appeal before the Hon'ble High Court.

**Decision**

i. The Hon'ble High Court noted that what was agreed between the assessee and its customers was that mere registration of a domain name did not create any proprietorship rights in the name used as the domain name or in the domain name registration either in the assessee or the customers or even any other third party.

ii. It accepted the submission of the assessee, that since it was not the domain name's owner, it could not confer the right to use or transfer the right to use the domain name to another person/entity.

iii. It further held that it was possible in a given situation that a domain name may have the attributes of a trademark. [on the basis of Section 2m read with Section 2zb of Trademarks Act, 1991].

iv. However, relying on the judgement of the Hon'ble Supreme Court in ***Satyam Infoway vs. Siffynet Solutions, (2004) 6 SCC 145***, it held that it is the registrant (and not the Registrar) who owns the domain name, and can protect its goodwill by initiating passing off action against a subsequent registrant of the same domain name/a deceptively similar domain name. Further, the Tribunal's reliance on the aforesaid judgment was misconceived as in the said case, the court was concerned only with the rights of the domain name owner and not the Registrar, while determining whether action could be initiated in relation to domain names. It further held that the aforementioned principle may have been attracted if the assessee had granted rights in or transferred the right to use its domain name, i.e., Godaddy.com, to a third person (which was not so in the instant case).

v. It thus concluded that the fee received by the assessee for registration of domain names of third parties, i.e., its customers, could not be treated as royalty.

ML-192

## 3 *CIT (IT) vs. Piaggio & C.S.P.A [(2023) 157 taxmann.com 622 (HC - Bombay)]*

**Where assessee entered into two agreements with its AE and Assessing Officer concluded that second agreement was only an extension of first agreement and, therefore , tax rate applicable would be 20 per cent and not 10.56 percent , since old agreement which provided trademarks to be used by assessee were only restricted to Ape 501 and Ape 601, whereas, as per new agreement, assessee had provided license to manufacture and sell vehicles under name of Ape, which encompassed all kinds of vehicles and the territory which was covered under old agreement was different from territory that was covered under new agreement, second agreement was not an extension of earlier agreement.**

**Facts**

i. Assessee was in business of manufacture of motorized two wheelers and three and four-wheeled light goods transport vehicles.

ii. It received royalty income and technical fees for services rendered in India to its AEs. It had entered into two agreements with its AE in March 1998 and April 2008.

iii. The AO concluded, after considering both agreements, that second agreement was only an extension of first agreement and, therefore, tax rate applicable u/s 115A of the Income-tax Act, 1961 would be 20 per cent and not 10.56 per cent.

iv. The Hon'ble Tribunal observed that there was difference between the two agreements and also the law as prevailing and that old agreement which provided trademarks to be used by assessee were only restricted to Ape 501 and Ape 601, whereas, as per new agreement, assessee had provided license to manufacture and sell vehicles under name of Ape, which encompassed all kinds of vehicle and also observed that the territory which was covered under old agreement was different from the territory that was covered under new agreement and thus, the second agreement was not an extension of the earlier agreement.

v. Aggrieved, Revenue filed an appeal before the Hon'ble High Court.

**Decision**

i. The Hon'ble High Court held that these were factual findings and also possible findings which by no stretch of imagination could they be termed as perverse.

ii. Accordingly, the Hon'ble High Court dismissed the Revenue's appeal by holding that no substantial question of law arose.

## 4 *PCIT vs. Inductis India (P.) Ltd. ([(2023) 157 taxmann.com 87 (HC Delhi)]*

Where assessee-company was a debt free company question of receiving any interest on receivables would not arise and thus, adjustment made by AO on account of interest on outstanding receivables was liable to be deleted.

**5** ***PCIT vs. Sony India (P.) Ltd. [(2023) 157 taxmann.com 466 (HC Delhi)]***

Where assessee incurred AMP expenses in respect of products of AE and TPO made upward adjustment on account of same, in view of fact that assessee had received compensation for AMP expenses incurred by it in terms of higher profitability on products sold and fact that comparables chosen by TPO had a net margin lower than that of the assessee, no upward adjustment was required to be made.

## C. TRIBUNAL

**6** ***Toyota Kirloskar Motor (P.) Ltd. vs. ACIT [(2024) 158 taxmann.com 79 (Bangalore Tribunal)]***

Where assessee had entered into international transactions including payment of royalty to its AE and applied TNMM at entity level after aggregating all international transactions but TPO had concluded that royalty should be separately benchmarked, since assessee's margins had been computed including royalty payment which was higher than margin of comparables and in case of comparables, margins were computed after including royalty and research and development expenses, no separate adjustment for royalty was required.

"The only religion that ought to be taught is the religion of fearlessness. Either in this world or in the world of religion, it is true that fear is the sure cause of degradation and sin. It is fear that brings misery, fear that brings death, fear that breeds evil. And what causes fear? Ignorance of our own nature."

— *Swami Vivekananda*

"You must not lose faith in humanity. Humanity is like an ocean; if a few drops of the ocean are dirty, the ocean does not become dirty."

— *Mahatma Gandhi*

# INDIRECT TAXES
# GST – Recent Judgments and Advance Rulings

CA Naresh Sheth CA Jinesh Shah


## A. WRIT PETITON

**1** ***Star Engineers (I) Private Limited vs Union of India - [Writ Petition No. 15368 of 2023] – HIGH COURT OF BOMBAY***

**Facts and Issues involved**

Petitioner is engaged in designing, developing, manufacturing, and supplying a wide range of electronic components for industrial purposes. It is a regular supplier to Bajaj Auto Limited (BAL) and delivers its products based on varying delivery terms as specified in the purchase orders received from BAL.

During F.Y. 21-22, the petitioner had carried out delivery of goods to several third-party vendors (as per instructions of BAL) and simultaneously invoices were correctly raised on BAL under Bill-to-Ship-to-Model.

However, while filing GSTR-1 for the periods July 2021, November 2021 and January 2022, the petitioner inadvertently reported the GSTIN of the parties to whom the shipment was delivered instead of GSTIN of BAL.

The error was brought to the notice of the petitioner in the month of November 2022 which was beyond the time limit prescribed for rectification of GSTR-1 filed for the F.Y. 21-22 and hence, the GST Portal did not allow the petitioner to rectify such error.

Since the invoices were not reflected in the GSTR-2B of BAL, it was unable to claim ITC of the same. Therefore, at the time of processing the payment of the petitioner for the month of March 2023, BAL reduced the amount equivalent to the GST amount.

In light of the above, the petitioner requested the GST Authorities to allow him to rectify such error which was rejected by the GST Authorities solely on the ground that the limitation period for rectification of returns relating to the F.Y. 21-22 had expired.

**Petitioner's submission**

The petitioner submitted that it had fulfilled its tax obligation in relation to the supplies made to BAL which indicated that all the required taxes associated with the said transactions had been appropriately and duly paid by the petitioner to the Government and that the petitioner had also complied all GST Regulations.

Further, post identification of the inadvertent error made by the petitioner during filing of

ML-195

Form GSTR-1, it has taken proactive steps and secured confirmation from the respective third-party companies, confirming the non-availment of ITC at their end.

The petitioner contended that it is suffering a double prejudice as it is unable to recover the GST amount from BAL despite depositing the same with the Government. In other words, due to a mere procedural error made by the petitioner, it is facing financial hardship as it has paid GST at its own cost.

**Discussions by and observations of High Court**

On a combined reading of Sections 37, 38 and 39 of CGST Act, 2017, it cannot be said that the petitioner would be prevented from placing the correct position and having accurate particulars in regard to all the details in the GST returns being filed by it and that there would not be any scope for any *bonafide* rectification.

Denying the petitioner a chance to rectify a bonafide error only based on a technicality (i.e., no window being available on the GST Portal to rectify such inadvertent errors) defeats the intention of the GST legislation. In other words, the law cannot be interpreted to mean that correction of a *bonafide* and inadvertent error will be disallowed even though there was no loss to revenue.

There is no iota of any illegal gain being derived by the petitioner. Also, accepting any incorrect particulars filed in the returns under GST Regime would have serious cascading effect which would be prejudicial to both assessee (petitioner in this case) as well as third parties.

Therefore, a *bonafide*, inadvertent error in furnishing details in a GST return needs to be recognized, and permitted to be corrected by the department, when in such cases the GST Authorities are aware that there is no loss of revenue to the Government.

**Decision of High Court**

Hon'ble High Court directed the GST Authorities to permit the petitioner to amend/rectify the GSTR-1 for the relevant tax periods, either through online or manual means within a period of four weeks from the date of the ruling.

---

**2** ***TVL. Kavin HP Gas Gramin Vitrak – Madras High Court [W.P.(MD). Nos. 7173 and 7174 of 2023 AND W.M.P.(MD)Nos. 6764 and 6765 of 2023]***

**Facts and Issues involved**

Petitioner, engaged in business of Petroleum Gases and other Gaseous Hydrocarbons. Due to financial crisis the petitioner had submitted GSTR-3B physically and the same was already explained to the respondents in person through his Accountant. During scrutiny of returns filed by petitioner for FY 2017-18 and FY 2018-91, department issued SCN requiring petitioner to reverse the ITC claimed belatedly.

**Discussions by and observations of High Court**

Claim of ITC is described under Rule 60 of the TNGST Rules and the Form prescribed is Form GSTR-2, but the same was not notified.

Filing of GSTR-3B is to avail input tax credit and not for claiming the same. So the reversal of input tax for belated claim as per Section 16(4) of TNGST Act is not applicable since the filing of GSTR3B is not meant for

claim of input tax credit. GSTR-3B is not at all return as prescribed in Section 39 of the TNGST Act.

Sales made to the petitioner and the tax collected from the petitioner were duly reported by other end suppliers through their respective GSTR-1 and the petitioner could not claim the same since Form GSTR-2 is not notified. Hence, the petitioner has accounted the purchases and credited the tax payment made through tax invoice, claimed ITC in the books of accounts and availed the same through GSTR-3B filed physically. Hence, the allegation of belated claim of ITC itself is false and misleading.

Petitioner relied on the judgment rendered by the High Court of Punjab and Haryana in the case of ***Hans Raj Sons vs. Union of India and others in CWP No.36396 of 2019 dated 16.12.2019***, wherein the Hon'ble Court has allowed the taxpayer to file the return either electronically or manually if the portal is not opening.

In the said judgment, the High Court of Punjab and Haryana has relied on another judgment rendered in CWP No. 30949 of 2018, in the case of Adfert Technologies Private Limited Vs. Union of India and others, dated 04.11.2019. The same issue was also considered by the Madras High Court in W.P. No. 29676 of 2019, dated 06.10.2020, wherein it is stated as under:

*"19. Admittedly, the 31st of March 2019 was the last date by which rectification of Form – GSTR 1 may be sought. However, and also admittedly, the Forms, by filing of which the petitioner might have noticed the error and W.P. No.29676 of 2019 sought amendment, viz. GSTR-2A and GSTR-1A are yet to be notified. Had the requisite Forms been notified, the mismatch between the details of credit in the petitioner's and the supplier's returns might well have been noticed and appropriate and timely action taken. The error was noticed only later when the petitioners' customers brought the same to the attention of the petitioner.*

*20. In the absence of an enabling mechanism, I am of the view that assessee should not be prejudiced from availing credit that they are otherwise legitimately entitled to. The error committed by the petitioner is an inadvertent human error and the petitioner should be in a position to rectify the same, particularly in the absence of an effective, enabling mechanism under statute.*

*21. This writ petition is allowed and the impugned order set aside. The petitioner is permitted to re-submit the annexures to Form GSTR-3B with the correct distribution of credit between IGST, SGST and CGST within a period of four weeks from date of uploading of this order and the respondents shall take the same on file and enable the auto-population of the correct details in the GST portal. No costs."*

In the above said order, this Court has clearly held that in the absence of any enabling mechanism, the assessee cannot be prejudiced by not granting ITC. Therefore, following the aforesaid judgments this Court is inclined to set aside the impugned order.

If the dealer is not enabled to pay output tax, he is not permitted to file GSTR-3B return online and it indirectly obstructs the dealer to claim ITC.

In the present case the petitioner was unable to pay output taxes and so the GSTN not permitted to file GSTR-3B in the departmental web portal it is constructed that the petitioner had not filed GSTR-3B online, that resulted the dealer unable to claim his ITC in that particular year in which he paid taxes in his purchases.

Following the above said judgments, this Court is inclined to quash the impugned orders and accordingly the impugned orders are quashed. The respondents shall permit the petitioner to file manual returns whenever the petitioner is claiming ITC on the outward supply/sales without paying taxes. Further the respondents are directed to accept the belated returns and if the returns are otherwise in order and accordance to law, the claim of ITC may be allowed.

**Ruling of High Court**

Writ petition is allowed and departmental adjudication orders are set aside.

## B. RULINGS BY ADVANCE RULING AUTHORITY

### 1 *Punjab State Power Corporation Limited – Punjab AAR [Order No. AAR/GST/PB/22 dated 28.10.2022]*

**Facts and Issues involved**

Applicant is a Punjab Government Undertaking engaged in generation transmission and distribution of electricity. Applicant had availed working capital term loan of Rs. 2000 crores from Power Finance Corporation Limited ('PFC') during FY 2015-16. Applicant decided to prepay this loan of PFC. PFC raised demand of prepayment premium of Rs. 16,85,71,429 inclusive of 18% GST.

Applicant sought an advance ruling as to whether prepayment premium to be charged by PFC is taxable under CGST Act, 2017?

**Applicant's submissions**

CBIC vide its Circular No. 178/10/2022-GST dated 03.08.2022 has clarified that amounts paid for prepayment of loans constitutes consideration for supply. Such supply is, however, ancillary to the principal supply for which the contract is signed and hence, shall be eligible to be assessed as the principal supply.

In given scenario, principal supply is granting of loan by PFC which is exempted vide entry no. 27 of Notification No. 12/2017 – Central tax (rate) dated 28.06.17. Accordingly, ancillary supply of prepayment charges or premium is exempted from GST.

**Discussions by and observations of AAR**

CBIC Circular No. 102/21/2019-GST dated 28.06.2019 clarifies that additional/penal interest does not fall within the ambit of entry 5(e) of Schedule II to CGST Act and satisfies the definition of 'interest' as contained in Notification no. 12/2017 – Central Tax (rate) dated 28.06.2017.

On the other hand, Para 7.1.6. of Circular No. 178/10/2022-GST dated 03.08.2022 clarifies that amounts paid for late payment, early termination of lease or pre-payment of loan or amounts forfeited on cancellation of service by the customer as contemplated

ML-198

by the contract as part of commercial terms agreed constitutes consideration for supply of facility and are subject to GST. Such supply is, however, ancillary to the principal supply for which the contract is signed and hence, shall be eligible to be assessed as the principal supply. Naturally, such payments will not be taxable if the principal supply is exempt.

In the present case, applicant has simply stated that PFC has raised demand of prepayment premium of Rs. 16,85,71,429. It is not clear as to whether such premium includes 'additional/penal interest' or 'prepayment facility'.

In the event prepayment premium includes 'additional/penal interest', then as per CBIC Circular No. 102/21/2019-GST dated 28.06.2019, the transaction shall not fall within ambit of entry 5(e) of Schedule II to CGST Act and same is exempted from payment of GST in terms of Notification no. 12/2017 – Central Tax (rate) dated 28.06.2017.

In the event prepayment premium includes 'prepayment penalty', then as per CBIC Circular No. 178/10/2022-GST dated 03.08.2022, even though they may be referred to as fine and penalty, such payments amount to consideration for supply and the same is taxable. Such supply is, however, ancillary to the principal supply for which the contract is signed and hence, shall be eligible to be assessed as the principal supply. As the principal supply is services by way of extending loan, which is exempt from GST, pre-payment penalty is also exempt from GST.

**Ruling of AAR**

Prepayment premium charged by PFC shall not be taxable under CGST Act, 2017.

## 2 *Vrindavan Ladies Hostel – Tamil Nadu AAR [Advance Ruling no. 104/AAR/2023 dated 05.09.2023]*

**Facts and Issues involved**

Applicant is running a lady's residential hostel for college students and working people and is unregistered with GST. They also provide certain ancillary services such as housekeeping, security arrangements, television, parking facility, etc. Applicants collect around Rs. 6,500 per month per inmate for providing such boarding and lodging services. Further, these charges are dependent on number of people sharing the room.

Applicant has sought an advance ruling as to:

1) Whether the hostel and residential accommodation extended by the applicant hostel would be eligible for exemption under GST?

2) If eligible for exemption, whether applicant will be required to take registration under GST?

3) Whether any specific tariff entry is applicable to hostels under the Tariff Notification?

4) Whether, in the event of the hostel accommodation being an exempt activity, the incidental activity of supply of in-house food to the inmates

of the hostel would also be exempt being a composite exempt supply?

5) Whether judgement of Honorable Karnataka HC in case of Taghar Vasudeva Ambrish apply in present case?

**Applicant's submissions**

Entry 12 of Notification No. 12/2017 – Central Tax (rate) dated 28.06.2017 exempts services by way of renting residential dwelling for use as residence. Term 'residential dwelling' was defined under Para 4.1 of erstwhile CBIC-Education Guide to mean any residential accommodation but does not include, hotel, inn, guest house, etc. meant for temporary stay.

Honorable Karnataka HC in case of Taghar Vasudeva Ambrish held 'hostels' are exempted from GST under entry 12 of Notification No. 12/2017 – Central Tax (rate) dated 28.06.2017 as they squarely fall under the term 'residential dwelling' for students/ working people. Further, the expression 'residence' and 'dwelling' have more or less the connotation in common parlance and therefore, no different meaning can be assigned to the expression 'residential dwelling and it cannot be held that the same does not include hostels which are used for residential purposes by students or working women.

It may also be noted that the duration of stay in hotel is short and temporary in nature when compared to hostel which is for long term. The buildings used as hostels are 'residential buildings' as per Zoning Regulations and property tax receipt also categories hostels in 'residential zone' only.

**Department's submissions**

Services of applicant does not fall under services by way of renting residential dwellings for use as residence since they are letting out a single room to various inmates for various time periods for a pecuniary benefit.

Hostel accommodation is akin to sociable accommodation rather than what is commonly understood as residential accommodation. Hostel rooms are similar to hotel rooms which attracts GST.

Assuming that applicant's hostel is residential dwelling, same is being rented out for hostel facility or paying guest accommodation facility and not for use as residence.

**Discussion by and observations of AAR**

The fundamental issue to be addressed is whether hostel accommodation provided by applicant qualifies as residential dwelling for use as residence and thus eligible for exemption or not.

CBIC Education guide has interpreted the termed residential dwelling in terms of normal trade parlance but it does not include places meant for temporary stay.

Generally, renting of residential dwelling involves letting out any building or part of building by a lessor to a person to family against a room for using rooms. Thus, common understanding of term 'residential dwelling' is one where people reside treating it as a home. Moreover, renting does not include amenities like housekeeping or laundry, etc.

Applicant has rented out premises with the intention of providing hotel accommodation which is more akin to sociable accommodation rather than what is usually considered as a residential accommodation.

Further, a house/residential dwelling consists of one or more rooms but in instant case, single house with two or more rooms, where single family usually resides, is subdivided, and let out to different persons and rent is being collected on per bed basis with bundle of other services. Thus, the impugned accommodation does not qualify as residential dwelling and thus the question of using it as residence does not arise.

An accommodation is a location where someone accommodates whereas residence on other hand refers specifically to a place where someone resides permanently or for extended period of time. Hostels are nothing but accommodation which provide temporary accommodation of inmates. It is converting a residential dwelling into a hotel accommodation which eventually makes the same dwelling 'non-residential' and thereby, taxable.

**Ruling of AAR**

Applicant is not eligible for exemption under entry 12 of Notification No. 12/2017 – Central Tax (rate) dated 28.06.2017.

Applicant is required to be registered under GST, if its aggregate turnover exceeds twenty lakhs rupees.

Hostel accommodation services shall be liable to GST at rate of 18%.

The activity of supplying in-house food is in a composite manner and the hostel accommodation services provided being the principal supply which is taxable @ 18%, is the tax rate for the composite supply provided by them.

---

## 3 *Simmple Rajendra Shukla – Maharashtra AAR [2018] 93 taxmann.com 97 (AAR - Maharashtra)*

**Facts and Issues involved**

Applicant runs 'S' Tutorials and prepares the students for entrance examinations related to MBBS, engineering and other science related examinations.

Applicant has sought an advance ruling as to whether the services related to providing the coaching for entrance examination will come in the ambit of GST?

**Applicant's submissions**

Applicant has stated that the activity is covered by the Notification No. 12/2017-Central Tax (Rate) dated 28.06.2017 described 'Services provided by an educational institution to its students will be taxed at Nil rate.'

Applicant submitted that the words "Education" and "institution" has not been defined in GST Act. However, the dictionary meaning of Education means "Imparting of knowledge". The word institution as per dictionary meaning means an organization formed to provide services. Therefore in the layman's language the word education institution means an organization formed to impart educational services. The rendering of educational services falls under the chapter heading of 9992.

**Discussion by and observations of AAR**

Notification No. 12/2017 – Central Tax (Rate) dated 28.06.2017 exempts services provided by an educational institution to its students. The term 'educational institution' is defined under the said notification to mean an institution providing services by way of—

(i) pre-school education and education up to higher secondary school or equivalent; or

(ii) education as a part of a curriculum for obtaining a qualification recognized by any law for the time being in force; or

(iii) education as a part of an approved vocational education course.

Applicant runs a private institute 'Simmple Shukla's Tutorials' and is engaged in providing the service of teaching to the students of Class XIth and XIIth science. This activity prepares the students for entrance examinations related to MBBS, Engineering and other science related examinations. However her claimed institution " Simmple Shukla's Tutorials" is in no way covered in the definition of educational institution as given in the above notification.

The private institute does not have any specific curriculum and does not conduct any examination or award any qualification recognized by any law which would be covered in the above notification. The activity of applicant is not covered by the specific definition provided for interpretation of exemption notification.

**Ruling of AAR**

The coaching services provided for entrance examination shall be liable to GST at the rate of 18%.

"Feel nothing, know nothing, do nothing, have nothing, give up all to God, and say utterly, 'Thy will be done.' We only dream this bondage. Wake up and let it go."

— *Swami Vivekananda*

"It's the action, not the fruit of the action, that's important. You have to do the right thing. It may not be in your power, may not be in your time, that there'll be any fruit. But that doesn't mean you stop doing the right thing. You may never know what results come from your action. But if you do nothing, there will be no result."

— *Mahatma Gandhi*

ML-202

# CORPORATE LAWS

## Case Law Update

CS Makarand Joshi

### Companies Act – Case 1

**In the matter of Vijaya Hospitality and Resorts Ltd. vs. Tony P. A. NCLAT Chennai order dated 15th September 2023.**

Facts of the Case.

- M/s Vijaya Hospitality and Services Limited is the First Appellant (hereinafter referred to as "the company") was the original respondent in the company petition number CP/122/KOB/2019 filed before NCLT Kochi.
- Mr KC Baboo ['Second Appellant'] is the Chairman and Managing Director of the company, holding 52.86 % of the total shareholding of the company.
- Respondent Nos. 1 to 4 Mr Tony PA, Mrs Siji Tonyu, Mrs Manju Sudhesh & Mr Sudesh Thankappan] [hereinafter referred to as 'Minority Shareholders'] held 80,000 equity shares of the company, aggregating to 0.37 % of the total shareholding of the company. Minority Shareholders Respondent Nos. 1 to 4 were the original petitioners in the Company Petition number CP/122/KOB/2019 filed before the National Company Law Tribunal, Kochi ['NCLT Kochi'] bench under sections 59 and 62 of the Companies Act, 2013. ["the Act"].
- The Minority Shareholders had filed the aforesaid petition before NCLT Kochi seeking rectification of the register of members, an independent audit of the company's Accounts and valuation of shares before further allotment.
- Also, irregularities were alleged of unauthorised appointment of the Second Appellant, removal of certain directors through forged resignation letters and improper share allotment leading to a sudden increase in shareholding of the Second Appellant.
- While the NCLT Kochi was hearing a petition for oppression and mismanagement under sections 241 & 242 of the Act with respect to the First Appellant, it was seen that the Second Appellant and Mr. CK Sibi, former Chairman & Managing Director of company filed a petition before NCLT, Kochi seeking direction to allow them to infuse necessary funds into the company towards share capital for the purpose of repayment to Federal Bank as the company was in financial distress and the Federal Bank initiated

proceedings under the Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002.

- NCLT Kochi through an interim order dt:12.01.2017, allowed the Second Appellant and Mr C.K. Sibi to infuse the funds into the company as 'Share Capital' and the amount was appropriated against the dues of Federal Bank. NCLT Kochi further ordered the company to make preferential allotment by way of private placement of shares against the said amount.

- Thereafter, the petition for oppression and mismanagement was accepted by the NCLT, Kochi and the interim order allowing the infusion of funds by way of private placement was made part of the final order. Eventually, this final order in the matter of oppression and mismanagement was also upheld by NCLAT and Hon'ble Supreme Court vide its order dt: 14.12.2018 and dt: 06.05.2019 respectively.

- Thereafter, the Second Appellant convened a general meeting of the company to increase the authorised capital of the company and thereafter, a board resolution was passed to allot equity shares at par to the Second Appellant.

- Post the said allotment, the minority shareholders filed a petition under section 59 and 62 of the Act before NCLT, Kochi stating that, the allotment was made without obtaining a valuation report as required under section 62(1)(c) and rule 13 of Companies (Share Capital and Debentures) rules 2014. NCLT, Kochi *vide* order dated 10.03.2021, allowed the petition and ordered the cancelation of allotment and rectification of the register of members.

- Company and Second Appellant have challenged the said NCLT, Kochi order in this appeal.

**Appellant's contentions**

- **Rule 11 of the NCLT Rules, 2016 gives wide powers to NCLT to pass orders as it deems fit**: Second Appellant submitted that Rule 11 of the NCLT Rules, 2016 allows the NCLT to make such orders that may be necessary for meeting the ends of justice. Thus, while passing an order for the allotment of shares the tribunal is not bound to follow section 62 of the Act which is applicable when the company voluntarily wants to allot shares. The impugned NCLT Kochi Order dated 10.03.2021 is effectively modifying and reviewing the interim and final Orders in the matter of oppression and mismanagement which have actually attained finality.

- A perusal of the interim order dated 12.01.2017 makes it clear that it was considering the emergency situation where funds were infused into the Company ensuring its continued survival and the order was passed in pursuance of the vide powers that are conferred upon NCLT, under section 241-242 of the Companies Act 2013.

- While passing an Order for allotment of Shares in the exercise of its powers under the Act, NCLT is not bound to follow section 62 of the Act which is applicable when the company voluntarily wants to allot shares.

ML-204

- NCLT has failed to take into account the effect of section 242 sub-sections (5) & (6) of the Act which provide for any alteration made in the Memorandum of Association of a Company in pursuance of an Order passed under section 242 of the Act which shall have the same effect as if it had been duly made by the Company in accordance with the provisions of the Act.

- Sub-sections (5) & (6) of section 242 specifically protect the amendment made to the Memorandum of Association of the company which was in pursuance of and for the purpose of implementing the interim and final Orders dated 12/01/2017 and 18/04/2017.

- Application for infusing funds as share capital came to be made by minority shareholders when the company was in grave risk and in these circumstances no 'sub-Resolution' could possibly have been passed for allotment of shares. Therefore, any insistence upon complying with Rule 13 of the Companies (Share Capital and Debentures) Rules, 2014 would have frustrated the Order of NCLT.

- **Rectification of register of members cannot be the remedy:** Original petition CP/122/KOB/2019 before NCLT Kochi filed under section 59 of the Act only applies to cases where a transfer of existing shares of existing shareholders is recorded in the Register of Members without sufficient Cause. Whereas, NCLT had failed to take into account that the Second Appellant was allowed fresh shares in pursuance of the directions given by NCLT, Kochi vide interim and final Orders in the matter of oppression and mismanagement. and therefore, even if section 59 was to be made applicable to the present case, the allotment of Shares to the Second Appellant was with sufficient cause.

**Minority Shareholder's contention.**

- **Rule 11 of the NCLT Rules, 2016 gives wide powers to NCLT to pass orders as it deems fit**: The Second Appellant had invested a sum of Rs. 11,00,00,000/- into the company for clearing the arrears due to the Federal Bank and by virtue of the order of NCLT, was entitled to have shares allotted on "preferential basis by way of private placement". A Chartered Accountant was appointed for over-seeing the proper implementation of the NCLT Order. However, the new management did not permit the Chartered Accountants to get involved in the process of the implementation of the NCLT's Order and proceeded on its own.

- A resolution for the increase of authorised share capital was passed in the general meeting of the company and thereafter, the board of directors passed a resolution for the allotment of shares at par against the amount infused by the appellant.

- Without making a valuation of shares, the allotment was made to the Second Appellant, by virtue of such allotment he became the largest shareholder with shareholding rising from 4% to 52.86%. NCLT, Kochi order allowing the infusion of funds, only says that the allocation of shares would be done on a 'preferential basis' only by

way of private placement but has not specifically observed that the allocation need not be made under the provisions of section 62 or that the valuation of Rs. 10 to be given for the said allotment.

- Rule 13(g) of Companies (Share capital and Debentures) Rules, 2016 stipulates that the valuation of shares issued on a preferential basis, either for cash or for consideration, shall be determined on the basis of a Valuation Report of a Registered Valuer. In the Form PAS-3 allotting shares to the Second Appellant, the allotment was styled as one under section 62(1)(a) by describing the allotment as barred as "*pari passu*" with the existing shareholding.
- The Order dated 12.01.2017 passed by NCLT does not dispensed with the mandatory requirements of Section 62(1)(c) of the Act and the company cannot be an Appellant as the company is not an Aggrieved Party.
- **Rectification of register of members cannot be the remedy**: The Learned Counsel placed reliance on the decision of the Hon'ble Supreme Court of India in the matter of ***Ammonia Supplies Corp. (P.) Ltd. vs. Modern Plastic Containers (P.) Ltd. [1998] 17 SCL 463 (SC)/ [1998] 7 SCC 105***, wherein it was held that section 155 deals with the power of the Company Court to rectify the Register of Members maintained by the Company. The very word rectification connotes something what ought to have been done and what ought not to have been done was done requiring correction. Rectification in other words is a failure on the part of the Company to comply with the directions under the 'Act'. In order to qualify any rectification, every procedure as prescribed under the 'Act' before recording the name in the Register of the Company has to be stated to be complied with by the Applicant. The word 'sufficient cause' is to be tested in relation to the Acts and the Rules.
- It is submitted that based on the ratio of this Judgment there cannot be any hesitation regarding the maintainability of an application for rectification in a case where the allocation of shares was done in violation of the mandatory statutory provisions.

**Held**

The main issue which arises in this Appeal is whether 'allotment of shares' on a 'Preferential basis by way of private placement', in pursuant to an Order passed under sections 241-242 of the Companies Act, 2013 requires adherence to section 62(1)(c) of the Act read with the applicable Companies Act (Share capital and Debentures) Rules, 2014.

- The contention of the Learned Counsel for the Appellants that the names of the 1st and 2nd Respondents are reflected in the attendance register of the minutes book of the annual general meeting and therefore, they consented to the said allotment of Rs. 10 face value cannot be sustained as the Register only reflects the assent of Respondents to the increase in the authorised share capital and does not in any manner indicate the consent to the issuance at face value. The said

allotment at face value is voted upon only through the Board of directors.

- Merely because the direction given by NCLT, Kochi does not specifically mention the fulfillment of mandatory requirements of Section 62(1)(c), it cannot be said that those provisions need not be complied with as it has not been specifically mentioned in the 'directions' and the same has been confirmed by both NCLAT and the Hon'ble Supreme Court.

- We are of the earnest view that in the facts of this case, 'private placement by preferential shares, allotment' has attained finality, but the 'procedure' to be adopted in this allotment has not been specifically stated by NCLT, Kochi and we observe that in the interest of the proper conduct of the affairs of the company and for it to be 'just and equitable', it is imperative that the procedural requirements under section 62(1)(c) read with the relevant Rules under this Provision, be complied with.

- The Hon'ble Delhi High Court in the matter of ***SAS Hospitality (P.) Ltd vs. Surya Constructions (P.) Ltd [2018]*** has held that any dispute pertaining to the rectification of the Register of Members can be decided under section 59 of the Act and the Paragraph relevant to this proposition is detailed as hereunder:

  *"The effect of the increase in the share capital and allotment of the same to any person has an automatic effect, i.e., it results in the alteration of the register of members under section 59 of the 2013 Act. Thus, while the power to issue share capital vests in the company, the said power, without the section implementing the said issuance, is of no effect, and has no consequence. Any dispute in respect of rectification of the register of members under section 59, can be raised by any person aggrieved to the Tribunal i.e., the NCLT."*

- In the light of the aforenoted decision, NCLAT was of the earnest view that the issue regarding cancellation of allotment of shares to the Second Appellant would fall within the scope and ambit of section 59 of the Act.

The contention of the Appellants that Section 62 of the 'Act' need not be adhered to, does not hold good as it is a settled rule of interpretation of statutes that when power is given under the statute to do a certain thing in a certain way, the thing must be done in that way or not at all. The Hon'ble Supreme Court in a catena of judgments has reiterated this principle. NCLAT, Chennai further held that the direction given by the NCLT, vide Order dated 12.01.2017 has to be complied within the framework of law as provided for under section 62(1)(c) of the Act. NCLAT further held that the issue which has attained finality is the 'allotment of shares' and not the 'procedure to be adopted for allotment'. For all the foregoing reasons, this Company Appeal (AT) (CH) No. 18/2021 is dismissed as devoid of merit.

## SEBI - Case 1

### Securities and Exchange Board of India's Adjudication Order in The Matter of Setubandhan Infrastructure Limited

#### Facts of The Case

1. Securities and Exchange Board of India ('SEBI') received various complaints against Setubandhan Infrastructure Limited., ('SIL' / 'Company') (Formerly

known as Prakash Constrowell Ltd.), alleging that despite the company being in losses, based on the disclosure made after 2016, the share price went lifetime high, and the promoters off-loaded their shares in the market.

2. Further, it was also alleged on the company that the manner of provisioning of bad debts made were suspicious for the FY 2019-2020.

3. SIL was listed on the Bombay Stock Exchange ('BSE') and the National Stock Exchange ('NSE').

4. SEBI conducted an investigation in regards to the same matter and the preliminary investigations revealed that there were financial irregularities.

5. Pursuant to which a detailed investigation was done by SEBI for four financial years (f.y') commencing from f.y. 2016-2017 upto f.y 2019-2020 (hereinafter referred to as 'Investigation period' / 'IP').

6. Further, SEBI appointed an independent forensic auditor, BDO India LLP to conduct a forensic audit for the years mentioned in the investigation period.

7. A detailed investigation report was prepared by the forensic auditor which revealed that former independent directors and members of the audit committee of SIL Mr. Vishal Mukesh Ahuja ('Noticee No.1') and Mr. Prashant Prabhakar Gadkari ('Noticee No. 2') were involved in financial irregularities of the company which were observed during their tenure.

8. In view of the same, SEBI alleged Noticee's to be in violation of the provision of SEBI Listing Obligations & Disclosure Requirement Regulations, 2015 ('LODR Regulations') and SEBI circulars issued in this regard.

**Charges Levied**

1. Noticee's were alleged to have violated the provisions of:

   Regulation 18(3) r/w clause A(1), (4), (11) under Part C of Schedule II of LODR regulations for failure in discharging their duties of overseeing the financial reporting process and ensuring the disclosure of financial information of SIL.

**Contentions by the Noticees:**

1. **Noticee's involvement in the financial irregularities of the company:**
   - Noticee 1 contended that his appointment was made on the condition that he will not be involved in the affairs of the SIL.
   - Further Noticee 1 never attended any Board meeting or audit committee meeting during his tenure as director of SIL.
   - Noticee also contended that he never received any Notice or agenda of such meetings and hence, never received any remuneration for the same and a document showing otherwise should be considered as fictitious.
   - Noticee 2 contended that he never attended any Board Meeting or Audit Meeting of SIL during f.y 2016-17 to 2018-19 nor any remuneration was paid to him for said purpose.

ML-208

- Also, Noticee 2 mentioned that the statements recorded by SEBI of other Directors and Audit Committee members of SIL during the same time period corroborates that he never attended any such meeting either of the Board or Audit Committee.
- Hence as the Noticee 2 never attended any such meetings the irregularities observed in the financials of the company like round-tripping of funds through circular transactions, Misrepresentation of closing balances, Non- disclosure of RPT etc. cannot be attributed to the Noticee 2 and he was not aware of the same.
- Further during the hearing the Noticee submitted that Mr. Prafulla Bhat (past director of SIL) was behind the entire manipulation and fraud.
- Further, in order to conduct an enquiry an opportunity of a personal hearing was granted to Noticee 2 which he failed to appear before SEBI and rather choose to reply vide email stating that he did not have information to be provided to them as he was not part of day-to-day affairs of the company and was nowhere concern with any transaction and/or deals of SIL.

**Submissions by the Adjudicating Officer**

1. **Noticee's involvement in the financial irregularities of the company:**

- SEBI was of the view that Noticee no.1 and Noticee No.2 being Chairperson and Member of Audit Committee respectively failed in their duty to oversee the diversion of the Income of the company to the connected entities and also failed to block the projects being subcontracted to the connected entities as mentioned below:

***A. Diversion of funds by improper write-off of payments and balances***

a) SEBI noted that payments and receivable balances amounting to Rs. 11.23 crore were written off by SIL in the expense ledger viz. "rate, diff & discount a/c" and in most of these party ledgers, there was no invoice booking and neither there were any payable opening balances as on April 01, 2016.

b) Since the company could not provide any documentation or explanation to corroborate the genuineness of these transactions or justification for its writing off, the payment to these parties with no underlying basis/transactions and subsequent write-off to the expense ledger was observed to be a diversion of funds.

c) Hence SEBI was of the view that the Noticees failed to monitor the diversion of funds by improper write-off of payment and balances and accordingly, failed in their duties.

***B. Unreasonable write-off of Project Work in progress***

a) SEBI noted with respect to the captioned subject that from IR it can be seen that there were six projects in which Work in progress ('WIP') of the previous period was neither billed to the client nor reflected in the closing balance of the subsequent period and the variance between opening and closing WIP was expensed off to the extent of Rs. 25.76 crore.

b) This indicated that Noticees failed to monitor the irregularities with respect to the work in progress.

***C) Non-recovery of high ageing advances resulting in the misutilisation of funds***

a) SEBI here noted that advances of Rs.27.91 crore (Rs.25.86 and Rs. 205 crore) were paid to multiple parties wherein there was no expense booking and subsequent recovery during the IP and that in FY 2019-20, provision for doubtful advances of Rs.4.21 crore was created against these advances and no details were provided to the clarifications sought from the company.

b) Further in addition to the above, SEBI Noted that the payments to these parties were outstanding with high ageing and appeared to have resulted in the misutilisation of funds.

c) Hence in view of the aforementioned, it was construed that the Noticees failed to monitor the non-recovery of high ageing advances resulting in the misutilisation of funds by the company.

***D. No documentation for the purchase and sale of fixed assets with connected entities***

a) Based on IR, SEBI noted that SIL purchased land and building (Floor No. 2 & 3 of Pinnacle Mall) from Silver Key Developers Pvt. Ltd (Erstwhile Atal Buildcon. Pvt. Ltd), an Associate company of SIL on 30th June 2019 amounting to Rs.22 crores.

b) This property was built by Prakash Construwell Ltd as per its website.

c) Further, SIL sold Maserati - Gran Turismo Sports Car to Mr. Prafull Bhat (a past director of SIL) on 31 July

d) SEBI further noted from IR that a DG set was sold to Atal Buildcon Pvt Ltd of Rs. 0.12 crore on 28th June 2018 and that for all the above transactions, supporting documents such as Transfer Agreement, Valuation Reports, Invoices etc. were not provided and the company

also did not provide physical verification and valuation reports of fixed assets and therefore it was unable to comment on the closing balance of property, plant and equipment of Rs. 31.33 crore as on March 31, 2020.

e) The company was not able to prove ownership and failed to produce any supporting documents for the transaction.

f) SEBI's view on Noticees contention that they never attended any audit committee meeting, nor received notice of such meeting, nor signed minutes of such meeting was not tenable as the Annual Report of the company not only confirms that the Noticees were a member of the Audit Committee but also confirm attending the meeting and the receipt of remuneration for the said purse as well.

g) If the Noticees were claiming the information provided in the Annual Report as wrong, then they could have produced relevant documents to substantiate their claims and also for any action taken against the company for publishing untrue information in the annual report regarding the Noticees.

h) Hence SEBI mentioned that it was pertinent to note here that the Annual Report of a company was a public document and easily available in the public domain and considering the Noticees being directors in SIL, it was accessible to them.

- SEBI noted that Noticee No.1's submission that he was unaware of the irregularities and that his appointment was made on the condition that would not be involved in any manner whatsoever in the affairs of SIL showed his lax attitude towards his profession and does not absolve him of his duty towards the interest of investors and that he being a Chartered Accountant i.e. a qualified professional should had taken due care and caution while being Chairperson of the Audit Committee and cannot feign ignorance contending that he was not aware of the affairs of the Company since he had a formidable responsibility with respect to the presentation of the true picture of financials and should have raised probing questions. Hence Noticee 1 statement that he was not aware of the responsibility of an independent director or audit committee is not acceptable.

- SEBI further noted that Noticee no. 2 (Independent Director and member of Audit Committee) had also attended 22 board meetings held during FY 2016-17 to FY 2018-19 and all 18 audit committee meetings held during his tenure as mentioned in respective years annual report. In this regard, Noticee No.2 made a blanket statement that he was not attending the office on a day-to-day basis and was not part of

the day-to-day business affairs of the company. In this regard, SEBI noted that Noticee no. 2 cannot absolve himself and do away with the daunting task of him being a member of the Audit committee which casts immense responsibility which he failed to do.

- SEBI then concluded with the statement that any person who is required to oversee/present a true and fair picture of the financials of a company and is not able to do so and engages in manipulating/misrepresenting (directly or indirectly) financials of a company then such person is depriving the investing public the statutory rights available to them, then SEBI is duty bound to ensure that the investing public are not deprived of any statutory rights available to them.
- Thus, the facts of the case clearly brought out the default made by the Noticees and their failure in fulfilling their responsibility endowed upon them by virtue of them being audit committee members. Hence, noted that the Noticees failed to present a true and fair picture of the financials of the company and thereby have violated the relevant provisions of SEBI (LODR) Regulations.

**Penalty**

Mr. Vishal Ahuja (Chairman of the audit committee) and Mr. Prashant Prabhakar Gadkari (Member of the audit committee) were penalized with Rs. 25,00,000/- each under section 15HB of the SEBI Act 1992.

## IBC Case – 1

**In the matter of *Mr. Vishal Chelani & Ors. (Appellant) vs Mr. Debashis Nanda (Respondent)* at the Hon'ble Supreme Court dated 6 October 2023.**

**Facts of the Case**

- Canara Bank (Erstwhile Syndicate Bank) filed an application u/s 7 of the Insolvency and Bankruptcy Code, 2016 (IBC) against M/s Bulland Buildtech Private Limited (Corporate Debtor/ CD) before the National Company Law Tribunal (NCLT), New Delhi Bench
- The appellants Mr. Vishal Chelani & Ors., were the home buyers, who opted for allotment in a real estate project of the CD. Aggrieved by the delay in the completion of the project, the appellants approached the Uttar Pradesh Real Estate Regulatory Authority (UPRERA)which upheld the entitlement to refund amounts deposited by the, together with interest.
- In the meantime, proceedings under the IBC were initiated.
- During proceedings after due consultations by the Committee of Creditors (CoC), a resolution plan was presented to NCLT.
- In the resolution plan, a distinction was made between home buyers, who had opted or elected for other remedies such as i.e. applying before the Real Estate Regulatory Authority (RERA) and having secured orders in their favor, and those who did not do so. Home buyers who did not approach authorities under RERA were given the

benefit of 50% better terms than that given to those who approached RERA or who were decree holders.

- The appellants felt aggrieved stating that the NCLT committed an error in holding those homebuyers who obtained a degree under RERA for a refund of their amount as financial creditors however this application was rejected by the NCLT.

- Their appeal before the National Company Law Appellate Tribunal (NCLAT) was also dismissed on the ground that once the recovery certificate has been issued by the party in possession of the recovery certificate is to be considered as a financial creditor hence the appellants approached the Hon'ble Supreme Court to challenge the decision of NCLAT which ruled that beneficiary of a decree by UPRERA the order of resolution professional proposing that they be treated differently from the other home buyers allottees does not call for interference.

**Arguments of the Appellant**

- Appellants stated that they are no longer interested in the refund of money but are focused solely on the allotment of the flat. The flat is now priced three times more than in the resolution plan and is beyond the reach of homebuyers.

- The definition of the financial debt u/s 5(8)(f) of IBC which was amended in 2018 to include homebuyer allottees in real estate projects as financial creditors, no distinction can be made between different sets of such homebuyer allottees. *Reference was made to the decision of the NCLT, Mumbai, in the case of Mr. Natwar Agrawal (HUF) vs. Ms. Ssakash Developers & Builders Pvt. Ltd.*

**Arguments of the Respondent**

- As per the scheme of the RERA Act and the regulations, the appellant, after obtaining a decree from the UPRERA regarding the refund of the amount invested for the purpose of purchasing the flat, would fall within the definition of a financial creditor and not in a class of creditor for the purpose of asserting their claim as such before the RP.

- The appellants cannot be permitted to secure two benefits. By approaching the UPRERA, they became part of a different sub-class of home buyers entitled to specified amounts and, therefore, were considered unsecured creditors. This contrasts with allottees who had not invoked RERA remedies. It is submitted that such home buyers relinquished their rights under Section 18 of the RERA.

**Held**

- With the amendment in the definition of financial debt and the introduction of the explanation to Section 5(8)(f) of the IBC, homebuyers and allottees of real estate projects were included in the class of financial creditors because financial debt is owed to them. On a plain reading of Section 5(8)(f) of the IBC, no per se distinction is made between different classes of financial creditors for the purposes of drawing a resolution plan.

Consequently, the reasoning of the Mumbai Bench of NCLT in the case of Mr. Natwar Agrawal (HUF) vs. Ms. Ssakash Developers & Builders Private Limited was correct. The Resolution Professional's perspective seems to be that when an allottee seeks remedies under RERA and opts for a refund in accordance with the order in their favor, they cannot be considered part of the class of homebuyers. According to this view, only homebuyers are eligible to approach and seek remedies under RERA, and no others.

- In the above circumstances, to treat a particular segment of that class differently for the purposes of another enactment, on the ground that one or some of them had elected to take back the deposits together with such interest as ordered by the competent authority, would be highly inequitable.
- As held in *Natwar Agarwal (HUF) (Supra)* by the Mumbai Bench of NCLT, the underlying claim of an aggrieved party is crystallized in the form of a court order or decree. That does not alter or disturb the status of the concerned party—in the present case, the allottees as financial creditors.
- Furthermore, Section 238 of the IBC contains a non-obstante clause that gives overriding effect to its provisions. Consequently, its provisions acquire primacy and cannot be read as subordinate to the RERA Act. In any case, the distinction made by the RP is artificial and amounts to "hyper-classification."
- In view of the foregoing reasons, the appellants were declared as financial creditors within the meaning of Section 5(8)(f) (Explanation) and entitled to be treated as such along with other homebuyers/financial creditors for the purposes of the resolution plan, which was awaiting a final decision before the NCLT. The appeal was allowed on the above terms.

"The greatest truths are the simplest things in the world, simple as your own existence."

— *Swami Vivekananda*

"To give pleasure to a single heart by a single act is better than a thousand heads bowing in prayer."

— *Mahatma Gandhi*

ML-214

# OTHER LAWS
# FEMA – Update 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 Notification

### 1. Foreign Exchange Management (Manner of Receipt and Payment) Regulations, 2023 - No. FEMA 14(R)/2023-RB

RBI has notified a new Notification No. FEMA 14(R)/2023-RB dated December 21, 2023 on Manner of Receipt and Payment under FEMA in suppression of earlier issued Notification No. FEMA 14(R)/2016-RB dated May 02, 2016. This notification deals with the permitted modes by which a person resident in India can receive or pay for transactions with persons resident outside in India in relation to various types of trade and non-trade transactions.

We have provided below an analysis of changes in the new FEMA 14(R)/2023-RB:

- Under the new Notification, RBI has segregated the applicable regulations for Trade Transactions and Non-Trade Transactions. Trade transactions would entail payments/receipts in relation to exports and imports. Non-Trade transactions as the name suggests would include non-export/import transactions. This would include transactions such as investments, loans and other type of current/capital account transactions.
- In erstwhile FEMA 14(R)/2016-RB dated May 02, 2016, Regulation 3 & 4 dealt with receipt in foreign exchange and Regulation 5 & 6 dealt with payment in foreign exchange. The new Notification has merged both receipt and payment transactions in one single regulation. Regulation 3(2)(I) of the new Notification deals with Receipt & Payment for export to or import from the countries given below of eligible goods and services and Regulation 3(2)(II) of the new Notification deals with other than trade receipts and payments.
- Trade Transactions:

i. Nepal and Bhutan: Similar to erstwhile FEMA 14(R)/2016-RB, payment and receipt is permitted in Indian Rupees. Receipts for exports from India where importer in Nepal has been permitted by the Nepal Rashtra Bank can be in foreign exchange.

ii. Member countries of Asian Clearing Union (other than Nepal & Bhutan): The new FEMA 14(R)/2023-RB merely permits receipt or payment

ML-215

through ACU mechanism or as per the directions issued by the RBI. Such mechanism or directions have not been elaborated further and can be expected to probably form a part of the revised Master Direction. We shall need to await further guidance in this regard. Until then, the ACU mechanism would need to be followed. It should also be noted that in the erstwhile FEMA 14(R)/2016-RB, separate directions were available for Myanmar and Iran. Such separate directions are not forming part of the new notification.

The clarification has continued from erstwhile FEMA 14(R)/2016-RB in case of imports where the goods are shipped to India from a member country of the ACU (other than Nepal and Bhutan) but the supplier is resident of a country other than a member country of the ACU. In such cases, the settlement is permitted outside of the ACU mechanism in Indian rupees or in any foreign exchange.

iii. Countries other than member countries of ACU: No change in comparison to erstwhile FEMA 14(R)/2016-RB. Receipts and Payments are permitted in Indian Rupees or in any foreign exchange.

It should be noted that that erstwhile FEMA 14(R)/2016-RB provided that receipts and payments in relation to exports and imports should be in the currency appropriate to the place of final destination in case of exports (irrespective of country of resident of buyer) and country of shipment in case of imports. Further, Third Party receipt/payments were also permitted under the erstwhile FEMA 14(R)/2016-RB. These have not found their way into the new FEMA 14(R)/2023-RB but could possibly form part of the directions to be issued by RBI. We need to await such directions before commenting if earlier liberalization has now been disallowed.

iv. Further, the Notification provides that receipts and payments may also be made in a manner as may be provided in the extant Foreign Trade Policy framed by the Central Government irrespective of the above mentioned regulation.

- Other than Trade Transactions:

i. Nepal and Bhutan: Similar to erstwhile FEMA 14(R)/2016-RB, payment and receipt is permitted in Indian Rupees. However, in case of overseas investment in Bhutan, payment has been permitted in foreign currency also.

ii. Other Countries: No change in comparison to erstwhile FEMA 14(R)/2016-RB. Receipts and Payments are permitted in Indian Rupees or in any foreign exchange.

Separate head for non-trade transactions with ACU countries (other than Nepal and Bhutan) is not provided. All transactions can be undertaken in Indian Rupees or in any foreign exchange.

- Payment and receipt in India for any current account transaction, other than a trade transaction, between any PRII and

a PROI, who is on a visit to India, can only be made in Indian Rupees which also includes debit/credit to permitted bank accounts as per FEMA.

**FEMA Notification No. 14(R)/2023-RB dated December 21, 2023**

***(Comments: One of the major salient changes between both the notifications relates to use of the words "freely convertible currency" in erstwhile FEMA 14(R)/2016-RB in comparison to use of the words "any foreign currency" in the new Notification FEMA 14(R)/2023-RB. While both terms are not defined as such under FEMA, the change could have manifold implications. In the original FEMA 14/2000-RB, the term permitted currency was defined which meant a foreign currency which is freely convertible. What is 'freely convertible' can be borrowed from the International Monetary Fund (IMF) according to which, Euro only, the Japanese Yen, the Sterling Pound, the U.S. Dollar and Chinese Renminbi fall in the category. It would thus mean that with the use of the term 'any foreign currency' in the new Notification FEMA 14(R)/2023-RB, monies can be received or paid in other currencies (in addition those listed earlier) as well.***

***Certain definitions such as Authorised Dealer/SNRR account/FCNR/NRE account as compared to erstwhile FEMA 14(R)/2016-RB have not found their way into the new notification. This could partly be attributed to the fact the some of the definitions were redundant and did not add much value whereas removing the definitions in relation to types of bank accounts needs to be understood further.***

***Regulation 4 of the erstwhile FEMA 14(R)/2016-RB provided manner of receipt in 'certain cases'. These included permitted receipt in the form of bank draft, cheque, pay order, foreign currency notes/travelers cheque from a buyer during his visit to India (subject to conditions), by debit to FCNR/NRE/SNRR account maintained by a PROI (overseas buyer) with an AD or an AD Bank, in rupees from the credit card servicing bank in India, from a rupee account held in the name of an Exchange House (subject to conditions), any PRII may also receive any payment for other than exports by means of postal order issued by a post office outside India or by a postal money order issued by such post office, etc. These have not found their way in the new Notification FEMA 14(R)/2023-RB. We need to wait and check if they would be included in the RBI Master Directions failing which further analysis would be required for understanding implications of inclusion.***

***Similarly, Regulation 6 of the erstwhile FEMA 14(R)/2016-RB provided manner of payments in 'certain cases'. These included exchange through an international card held by him/in rupees from international credit card/debit card through the credit/debit card servicing bank in India, payments by PROI n rupees towards meeting expenses on account of boarding, lodging and services related thereto or travel to and from and within India of a person resident outside India who is on a visit to India, by credit to SNRR account maintained by a PROI (overseas seller) with an AD or an AD Bank in India for imports into India, etc. These have not found their way in the new Notification FEMA 14(R)/2023-RB. We***

***need to wait and check if they would be included in the RBI Master Directions failing which further analysis would be required for understanding implications of inclusion.***

## B. Update through A.P. (DIR Series) Circulars

### 1. Submission of statements/returns on CIMS Portal

The following A.P. (DIR Series) Circulars have been issued by RBI on 22nd December 2023:

- A.P. (DIR Series) Circular No.09 - Rupee Drawing Arrangement - Submission of statements/returns on CIMS Portal
- A.P. (DIR Series) Circular No. 10 - Trade Credit for imports into India – Submission of return on issuance of bank guarantees for Trade Credits on the Centralised Information Management System (CIMS)
- A.P. (DIR Series) Circular No.11 - Liberalised Remittance Scheme (LRS) for Resident Individuals- Reporting of monthly return and daily transactions
- A.P. (DIR Series) Circular No.12 – CIMS Project implementation - Discontinuation of submission in legacy XBRL

Centralised Information Management System (CIMS) if the Reserve Bank's new data warehouse for data collection (URL: https://sankalan.rbi.org.in). Certain statements and returns which are required to be filed by AD banks with RBI have now been shifted to the new system. These include:

i. Rupee Drawing Arrangement - Statement E on total remittances received every quarter (newly assigned return code - 'R129')

ii. Trade Credits for imports into India - Quarterly statement on issuance of guarantees (newly assigned return code-'R131')

iii. Liberalised Remittance Scheme (LRS) for Resident Individuals- Reporting of monthly return and daily transactions (LRS monthly return and LRS daily return have been assigned return codes-'R089' and 'R010' respectively)

iv. Import of gold by EOUs, units in SEZ/EPZ and nominated agencies(M) - Statement on half yearly basis (end March/end September) showing the quantity and value of gold imported by the nominated banks/agencies/EOUs/SEZs in Gem & Jewellery sector, mode of payment-wise (newly assigned return code 'R132')

v. Import of gold by EOUs, units in SEZ/EPZ and nominated agencies(HY) - Statement on monthly basis showing the quantity and value of gold imports by the nominated agencies (other than the nominated banks)/EOUs/SEZs in Gem & Jewellery sector during the month under report as well as the cumulative position as at the end of the said month beginning from the 1st month of the Financial Year. (newly assigned return code 'R133')

***(Comments: The above mentioned circulars apply to AD Banks rather than to the general public since they relate to reporting to RBI by such AD Banks. It is however fruitful to know what data is being collected by RBI in relation to stakeholder transactions. RBI's data warehouse would be a large source of information for the present and the future.)***

ML-218

# THE CHAMBER NEWS

CA Neha Gada
Hon. Jt. Secretary

CA Vitang Shah
Hon. Jt. Secretary

Important events and happenings that took place online/ physical between **December 1, 2023 to December 31, 2023** 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 December 22, 2023 are as under:

| Type of Membership | No. of Members |
|---|---|
| Life Member | 06 |
| Half Yearly – Ordinary Member | 09 |
| Student Member | 01 |
| **Total** | **16** |

## II. PAST PROGRAMMES

| *Sr. No.* | *Date* | *Topics* | *Speakers* |
|---|---|---|---|
| **INDIRECT TAXES** | | | |
| 1. | 13.12.2023 | Recent Judgments in GST | *Group Leader:* CA Raj Khona<br>*Chairman:* Vinay Jain, *Advocate* |
| **INTERNATIONAL TAXATION** | | | |
| 1. | The International Taxation Committee had planned "2nd Residential Conference on Foreign Exchange Management Act (FEMA)" at Doubletree by Hilton, Ahmedabad. The session-wise detail of the program is as under: | | |

ML-219

| *Sr. No.* | *Date* | *Topics* | *Speakers* |
|---|---|---|---|
| a. | 15.12.2023<br>17.12.2023 | Paper I - Structuring of Foreign Investment-Using FDI, NRI, NRI NR, AIF, FVCI, etc and Interplay with other laws | CA Anup Shah |
| b. | | Paper II - Borrowings under FEMA | CA Vishal J. Shah |
| c. | | Overseas investment – structuring and issues | Siddharth Shah, *Advocate* |
| d | | Recent Developments | Mr. Suhas Bendre<br>Vide-President<br>– HSBC Bank |
| e. | | Brain Trust Session on various issues / case studies under FEMA | *Moderator*:<br>CA Vijay Gupta<br>*Panelists*:<br>CA Paresh P Shah,<br>CA Naresh Ajwani.<br>Mr. Suhas Bendre,<br>Vice-President – HSBC Bank<br>Mr. Vineet K. Jain,<br>– HSBC Bank |
| **MEMBERSHIP & PR** | | | |
| 1. | 12.12.2023 | Stop Counting Start Living! | Dr. Mickey Mehta |
| **STUDY CIRCLE & STUDY GROUP** | | | |
| 1. | 14.12.2023 | Recent Judgements under Income Tax Act | Tushar Hemani, *Advocate* |
| 2. | 21.12.2023 | Issues in Faceless Assessment - section 144B of Income Tax Act, 1961 | CA Pramod Shingte |
| **STUDENT** | | | |
| 1. | 06.12.2023 | Decoding GST Annual Returns and Reconciliation Statement: Student Workshop | CA Sumit Jhunjhunwala |
| 2. | 20.12.2023 | UDAAN - EPISODE 6 - Dual Perspectives: Solicitor ship in India & UK + Barrister Insights | Sharad Abhyankar, *Advocate*<br>Mr. Nilesh Modi, *Advocate*<br>Ms. Shivanee Srivastava |

ML-220

# International Taxation Committee

"2nd Residential Conference on Foreign Exchange Management Act (FEMA)" at Doubletree by Hilton, Ahmedabad from 15th December to 17th December, 2023

Inaugural Session: Seen from L to R: CA Paras K. Savla (Past President), CA Shabbir Motorwala (Vice Chairman), CA Tanvi Vora (Convenor), CA Paresh P. Shah (Member), CA Haresh Kenia (President), CA Kirit Dedhia (Chairman), CA Chintan Vajani (Conference Director), CA Anup Shah (Speaker), CA Manoj Shah (Past President), CA Mehul Sheth (Hon. Treasurer) and CA Naresh Ajwani (Member).

CA Haresh Kenia (President) giving his opening remarks

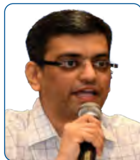
CA Kirit Dedhia (Chairman) welcoming the speakers and delegates

Release of CTC Publication "FEMA for Individual – A day to day practice": Seen from L to R: CA Tanvi Vora (Author), CA Paresh P. Shah (Author), CA Haresh Kenia (President), CA Kirit Dedhia (Chairman), CA Ashok Mehta (Chairman – Research & Publication Committee) and CA Chintan Vajani (Conference Director).

*Speakers*

CA Anup Shah addressing the delegates

Siddharth Shah, Advocate addressing the delegates



CA Vishal J. Shah addressing the delegates

Mr. Suhas Bendre (VP – HSBC Bank) addressing the delegates

Brain Trust Session: Seen from L to R: CA Paresh P. Shah (Panel Member), CA Vijay Gupta (Moderator), CA Naresh Ajwani (Panel Member), Mr. Suhas Bendre, VP – HSBC Bank (Panel Member) and Mr. Vineet K. Jain – HSBC Bank (Panel Member).

Group Photo

THE CHAMBER'S JOURNAL
Posted at the Mumbai Patrika Channel
Sorting Office, Mumbai 400 001.
Date of Posting: 15th-16th of Every Month

No. MCS/149/2022-24
R.N.I. No. MAHENG/2012/47041
Date of Publishing 12th of Every Month

# Tax and Accounts Professional (TAP) Course

**Online certification course** involving knowledge and skills **training** on **compliances** in **day-to-day business practices**

**Enroll Now**

## Get conceptual and practical training on

Income Tax

GST

Company Law

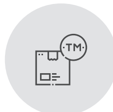
Labour Laws

Preparation of Financial Statements

MSME

Personality Development

MS Office



Trademarks

And Much More

- Live/Recorded Classes
- Placement Guidance and Assistance
- Scholarships
- Easy EMI options
- Professionals (CA/CS) as Instructors

**Enroll now for Level 1 and Level 2 batches starting next month**
and start your journey of learning and growth with **exclusive offers!**

"Evaluated by **AICTE** for **Ministry of Education's National Educational Alliance for Technology** (NEAT) Portal"

**MUMBAI:** 35, Bodke Building, Ground Floor, MG Road, Opp. Mulund Railway Station, Mulund (W), Mumbai - 400080
**Tel.:** +91-022-25934806/07/09, 25644807 | **Mobile:** +91 9322247686, 9619668669 | **Email:** sales.mumbai@taxmann.com

**Printed and Published by Shri Kishor D. Vanjara on behalf of The Chamber of Tax Consultants, 3 Rewa Chambers, Ground Floor, 31, New Marine Lines, Mumbai - 400 020 and Printed at Finesse Graphics & Prints Pvt. Ltd., 309 Parvati Industrial Premises, Sun Mill Compound, Lower Parel (W), Mumbai - 400 013. Tel.: 4036 4600 and published at The Chamber of Tax Consultants, 3, Rewa Chambers, Ground Floor, 31, New Marine Lines, Mumbai - 400 020. Editor : Vipul K. Choksi**