



Care & Compliance in undertaking Capital Transactions

Presentation by:

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WIRC – Direct Tax Refresher Course 2022

Capital Account Transactions

- ❑ Issue of securities
 - Shares or Debt
 - Consideration – cash, kind, restructuring (slump sale, merger or demerger)

- ❑ Movement of Securities – buyback, capital reduction, waiver, transfer

- ❑ Servicing of securities – Interest, dividend

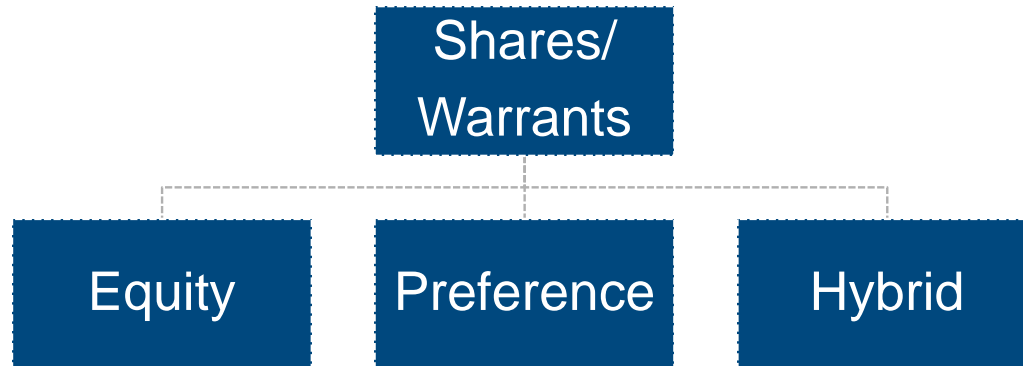
- ❑ Conversion of securities

- ❑ Introduction or withdrawal of partners capital from partnership firm



Issue of Shares

Type of Shares



- Private Ltd. – enable to issue hybrid shares – rigours of S. 43 and S. 47 (Notification No. GSR 464(E) dated June 5, 2015)
- Public Ltd. – limited flexibility
- Shares can be issued in Cash or Kind or both

Type of Shares

- ❑ Equity shares - Ownership of Companies
 - Economic ownership v. control
 - Inter-se interests - Partnerships, Joint ventures, families, trusts
 - Groups of shareholders, promoter group and others

- ❑ Preference shares
 - Convertible/ Non-convertible/Optionally convertible
 - Redeemable/ Irredeemable
 - Long dated
 - Issuance at par or at premium
 - Zero dividend ?
 - Redeemable at premium – with or without yield

- ❑ Share warrants
 - Unlisted – not regulated
 - Listed – regulated – SEBI (ICDR & LODR)
 - At pre-determined price within stipulated time period
 - At a price contingent upon conversion, e.g. average market value on date of conversion, etc.

Type of Shares

□ Hybrid Shares

- Linked to a specific asset
- Nomenclature – equity; quality – preference (irredeemable ?)
- Differential voting/dividend/redemption right
 - High / Low / None
- Differential dividend right
- Differential redemption right
- Cell companies – segmented
- Others – imagination is the limit

Issue of Shares – Company Law in brief

- ❑ Shares cannot be issued at a discount (S. 53) – exception IBC, debt restructuring – RBI guidelines

- ❑ Private Placement v. Public Issue
 - Threshold of 200 per financial year – LLP route ?
 - Compulsory listing in case of public issue
 - Offer for sale

- ❑ Preferential Issue (S. 62(1)(c) r.w.s. 42)
 - Board to identify select group of people for private placement – not more than 200
 - Valuation report of registered value – issue price cannot be less than value as per the report
 - Special resolution of the shareholders
 - Send Offer cum Application Letters in Form PAS-4 to identified persons within 30 days of recording the names of the identified persons.
 - Separate bank account for receiving share application money and use only after allotment (within 60 days from the date of receipt of money)

Issue of Shares – Company Law in brief

❑ Rights issue

- May be subscribed by all/part of the shareholders
- Right to renounce in favour of 3rd party (risk – S. 56(2)(x) ?)

❑ Benefits of Rights issue over a preferential issue –

- Preferential issue – requirement of a special resolution (S. 62(1)(c))
- Preferential issue – cannot be issued at a price lesser than the price determined by the registered valuer (Rule 13(3) of Companies (Share Capital and Debentures) Rules, 2014)
- Preferential issue – cannot utilize funds unless return of allotment is filed with ROC (S. 42(4))

Issue of Shares – Income Tax – S. 56(2)(viib)

- ❑ Capital account transaction – outside the normal scope of income – No tax

- ❑ S. 56(2)(viib) Unlisted company – issuance of shares are premium – justify the issue price otherwise difference between the issue price and fair value of shares regarded as income of the issuer
 - Exemptions – non-residents, venture capital undertaking, AIF I, AIF II and start-up (complex conditions)
 - Change of terms – post issue ?

- ❑ Fair market value of the shares shall be the value—
 - Rule 11UA –
 - book value – unadjusted for fair value of specified property or
 - Discounted Cash Flow Method – merchant bankers report
 - Alternative – to justify the price to AO based on value of assets including intangible assets
 - Issue of preference shares – S. 56(2)(viib) – valuation can be done by CA
 - Yield/risk based

Issue of Shares – Income Tax – S. 56(2)(x)

- ❑ S. 56(2)(x) – receipt of shares or securities without consideration or inadequate consideration as compared to the fair market value.
 - Circular No. 3/2019, Dated 21-1-2019

- ❑ Valuation Rule (report of CA or merchant banker – optional)
 - Listed Equity Shares
 - Bought on stock market – transaction price;
 - Transferred off market - lowest price on any stock exchange
 - Unlisted Equity Shares
 - Book value of shares, subject to adjustment for fair value of Shares, immovable property & other property (specified property) covered by Section 56(2)(x)
 - Other shares & securities – estimated price it would fetch if sold in the open market

Issue of Shares – Income Tax – S. 56(2)(x)

❑ Audited Balance Sheet –

- 56(2)(viib) - on the date of valuation or last approved balance sheet
- S. 56(2)(x) – FMV is to be determined basis audited financials as on the date of transaction and not on last drawn balance-sheet?
 - No clarity on how audited financials are to be obtained – particularly, problematic for a minority shareholder.

❑ Rule 11UA – crossholding, negative net worth, cost of compliance v. benefit ?

❑ Issue of shares – interplay between S. 56(2)(viiia) & S. 56(2)(x)

Issue of Shares – Income Tax – S. 56(2)(x)

□ Few issues

- Applicability to Issue of shares
 - Circular No. 3/2019, Dated 21-1-2019
 - Sudhir Menon HUF v. ACIT [2014] 45 taxmann.com 176 (Mum Trib.) – against
 - Analogy - Khoday Distilleries Ltd. v. CIT [2009] 307 ITR 312 (SC)
- Rights issue – subscription limit to applicant's shares
 - Sudhir Menon HUF v. ACIT [2014] 148 ITD 260 (Mum Trib.)
 - Others do not subscribe ?
- Rights issue – disproportionate allotment within family
 - Kumar Pappu Singh v. DCIT [2019] 174 ITD 465 (Visakhapatnam - Trib.)
- Bonus shares
 - DCIT v. Dr. Rajan Pai [2016] 48 ITR(T) 170 (Bangalore - Trib.)

Issue of Shares – Income Tax – S. 68

- ❑ Any sum received by an unlisted company on account of share application, share capital, share premium or any such amount is liable to explain source of funds
- ❑ For resident applicant – also nature and source (meaning source of source) to be explained.
 - Exemption - Venture capital fund or Venture capital company as per S. 10(23FB)
- ❑ Tax @ 60% u/s. 115BBE (+ 25% surcharge + 4% cess) + 10% penalty u/s 271AAC.

The company ought to obtain confirmation from the person about the source of funds at the time of issuance of shares to residents

Issue of Shares – FEMA in brief – FDI

❑ FDI Regulation – FEM (Non-debt Instruments) Rules, 2019

- Compulsory convertible debentures/preference shares – treated as equity
- Shares cannot be issued to non-resident for less than fair value (other than rights or bonus issue)
 - As per any internationally accepted pricing methodology for valuation on an arm's length basis - Chartered Accountant or Merchant Banker or Cost Accountant
- Sector specific conditions, % cap, restrictions, etc. to be complied with
- From 22.4.2020 - a citizen or entity (including the beneficial owner) of a country, which shares land border with India shall invest only with the Government approval.
- LLP at par with companies – for sectors where foreign investment up to 100% is permitted under automatic route and there are no FDI linked performance conditions (e.g. Financial Services, Construction Development: Townships, Housing, Built-up infrastructure, etc)
- NRI/OCI (including company, trust and partnership firm owned and controlled by NRIs or OCIs) – possible to invest on non-repat basis – deemed domestic investment – sectoral caps, pricing guidelines, reporting requirements, etc. – shall not apply

Issue of Shares – FEMA in brief – ODI

- ❑ ODI Regulation – FEM (Transfer or Issue of any Foreign Security) Regulations, 2004
 - Indian entities permitted to invest abroad – Company, LLP, registered partnership
 - Single regulation for equity and debt investment (including corporate guarantee)
 - Investment limit – upto 4 times the networth – more than \$1B (approval)
 - Prohibition – real estate and banking; Approval Route – Financial Services section
 - JV/WOS – to be engaged in a bona fide business activity - one level of SPV permitted – restriction on round tripping (RBI FAQ)
 - Shares cannot be subscribed/purchased by and Indian Entity of a foreign entity at a price higher than fair value
 - Investment is more than USD 5 million, Category I Merchant Banker (or an Investment Banker/Merchant Banker in the host country); and in all other cases CA or CPA

- ❑ Individuals – within LRS limit 2,50,000 \$
 - ODI Regulation – only operating companies, restriction on having subsidiary
 - LRS – portfolio investment is also permitted

Issue of Shares – Consideration in kind

❑ Consideration in Kind

- Fair value of consideration relevant for S. 56(2)(x), S. 56(2)(viib)
- Intangibles and services
- Non-compete

❑ Slump Sale / Slump Exchange

- Permission from AO u/s 281 ?

❑ Merger / De-merger

- All the pending proceedings, on-going litigation and outstanding tax demands will continue – S. 170
- Should not apply to demerger
- Impact on IBC ?

Issue of Debt

Types of Debt

- ❑ Loan
- ❑ Debentures
- ❑ Deposit
- ❑ Trade Advance / Capital Advance
- ❑ Promissory Note – other negotiable instruments
- ❑ Security Deposit
- ❑ Key Terms of a debt instrument –
 - Interest v. interest free v. deep discount bond v. redemption at premium
 - ECB v. INR
 - On demand v. fixed term
 - Secured v. unsecured
 - Convertible v. non-convertible

Debt – Company Law

- ❑ Debentures – S. 71 general compliance – requirement of debenture trustee if thresholds are crossed
- ❑ Deposits – Chapter V – what is not a deposit – secured/convertible debenture, intercorporate, etc.
- ❑ S. 180 borrowing beyond networth of the company – special resolution of shareholders
- ❑ S. 186(7) No loan shall be given at a rate of interest lower than the prevailing yield of one year, three year, five year or ten year Government Security closest to the tenor of the loan. Repayable on demand loan ?
- ❑ S. 186(2) shareholders approval (special resolution) to give loans beyond 60% of networth or 100% of free reserves – whichever is higher
- ❑ Important distinction between loan, deposit and debentures
 - Durga Prasad Mandelia v. ROC (61 Company Cases 479) (Bom HC)

Debt – Income Tax – Sec. 2(22)(e)

- ❑ S. 2(22)(e) – Loan or advance by an unlisted company to a shareholder (>10% equity shares) or to a concern in which such shareholder has substantial interest (>20%), such loan or advance would be deemed to be a dividend in the hands of the shareholder to the extent of accumulated profits of the unlisted company

Debt – Income Tax – Sec. 68

- ❑ Section 68 imposes obligation on taxpayers to satisfactorily explain credits in the books of accounts.
- ❑ Earlier only unlisted companies were liable to explain source of source for issuance of shares.
- ❑ **The Finance Act 2022 widened the scope to explain source of source in all cases (including loans or borrowing) whether the lender is a person resident or non-resident w.e.f. 01.04.2023.**
 - Exemption - Venture capital fund or Venture capital company as per S. 10(23FB) – practically irrelevant
 - No exemption for regulated financial institutions like – banks and systemically important NBFCs

Debt – Income Tax – Sec. 56(2)(x)

- ❑ S. 56(2)(x) – is *inter alia* applicable to shares and securities.

- ❑ Therefore if the debt is advanced pursuant to the issuance of a security instrument S. 56(2)(x) will apply.
 - Loan – not covered
 - Debentures (including CCD and OCD) – covered
 - Promissory Note – not covered ?
 - Deposit – not covered

- ❑ Importance of free transferability ?
 - Dahiben Umedbhai Patel v. Norman James Hamilton [1985] 57 COMP CASE 700 (Bombay HC) - Shares of a private company do not possess character of liquidity, they cannot be said to be marketable and, therefore, do not fall within definition of securities as a ‘marketable security’

- ❑ S. 56(2)(viib) – only applied on issue of shares and not on issuance of debt instrument

Debt – Income Tax – Interest Free Loan

❑ Concessional loan / Interest Free Loan

- S. 56(2)(x) – should not apply – loan not without consideration – for cash no clause on ‘inadequate consideration’
 - CIT v. Mr. Chandrakant H. Shah [2010] 9 TMI 1221 (Bom HC);
 - ITO v. Paramveer Abhay Sancheti [2018] 95 taxmann.com 258 (Nagpur - Trib.)
- 0% CCD – conversion terms – implied discount
- S. 28(iv) (TDS – 194R) – ‘benefit or perquisite’ – recent discussion in few public forums
 - Interest free loan not perquisite u/s 17(2) (prior to amendment)- V.M. Salgaocar & Bros. P. Ltd. v. CIT [2000] 243 ITR 383 (SC)
 - Shareholders activity - to enhance the value of the investment - Not arising ‘**from**’ business or profession – needs evaluation as to whether shareholder is acting as a shareholder or as a business associate
 - Revenue neutral - same amount ought to be allowed as an expense - hence, may be an academic exercise to charge u/s 28(iv) - CIT v. Excel Industries Ltd. [2013] 358 ITR 295 (SC)

Movement of Securities

TDS

TDS on Capital Transactions – 194Q

- ❑ S. 194Q deals with TDS @ 0.1% on purchase of 'goods' from a resident seller.
- ❑ CBDT vide Circular no. 13 of 2021 dated 30.06.2021 clarified non applicability of 194Q on securities/ commodities transactions traded through recognized stock exchanges or cleared and settled by the recognized clearing corporation located in IFSC.
- ❑ Whether Unlisted shares and securities covered ?
- ❑ Whether Undertaking is covered ?
- ❑ Definition of 'goods' not defined under the Act but defined differently under different laws.

Buyback

Buyback – Company Law

□ Key considerations :

- Source of buyback – fresh issue or free reserves or securities premium
- Debt to equity ratio – 2:1
- The payment to shareholders pursuant to buyback is 25% or less of the aggregate of paid-up capital and free reserves
 - No restriction on number of shares that can be bought back ? (next slide)
- Gap between two buybacks – 1 year
- Gap between a buyback and fresh issue – 6 months (unlisted) / 1 year (listed)
- Sec 230(10) - Sec 68 also applies to scheme of buyback u/s 230
 - Does not apply to reduction of capital u/s 66 – S. 230

Buyback – Company Law – 25% Condition

- ❑ Buyback of more than 25% equity shares permissible u/s 68 of Companies Act, 2013?

“the buy-back is twenty-five per cent or less of the aggregate of paid-up capital and free reserves of the company:

*Provided that in respect of the buy-back of equity shares in any financial year, **the reference to twenty-five per cent in this clause shall be construed with respect to its total paid - up equity capital in that financial year”***

- Buyback can only be of an amount equal to or less than 25% of the aggregate (or total of) paid-up capital and free reserves.
- Any other interpretation - limiting the buyback by reference to percentage of shares – renders reference to “free reserves” superfluous
- Proviso read as restriction on number of equity shares instead of amount paid
 - Tantamount to no restriction on the amount being paid to the equity shareholders pursuant to the buy-back
 - serious ramifications - injustice to the creditors

Buyback – Income-tax

- ❑ S. 115QA – tax @ 23.30% (20% plus 12% surcharge plus 4% cess) in the hands of domestic companies on distributed income on buy-back
 - Distributed income = amount distributed less amount received on issue (complex formula for determining the amount received)

- ❑ S. 10(34A) – exempts income in the hands of shareholders
 - S. 50CA? - no implication
 - If no buyback tax is payable by the Company, is exemption still available to shareholder u/s 10(34A)?
 - Covers dividend, capital gains, business income?
 - ***“any income arising to an assessee, being a shareholder, on account of buy back of shares by the company as referred to in section 115QA”***

Buyback – Income-tax

❑ S. 56(2)(x) - for the Company?

▪ Not a capital asset

- Commercial Tax Officer & Ors vs State Bank Of India [2016] 11 TMI 416 (SC);
- Vora Financial Services P. Ltd. v. ACIT [2018] TS 346 (Mum Trib)
 - Applies only to shares of another company

❑ Buyback at inflated price – dividend v. buyback

- Fidelity Business Services India Pvt. Ltd. v. ACIT [2018] 95 taxmann.com 253 (Karnataka HC) Buy back price paid by the assessee to its wholly owned holding company does not represent true fair market price of the share of the assessee then it is nothing but a dubious method of avoiding the tax in the garb of buy back.

Buyback – Income-tax

- ❑ Is redemption of preference shares a ‘purchase’ and consequently, a buyback ?
 - Definition under S. 115QA - Buy-back means “***purchase*** by a company of its own share in accordance with the provisions of **any law for the time being in force relating to companies**” - Does not restrict to buy-back u/s 68 of Co’s Act
 - Anarkali Sarabhai v. CIT [1997] 224 ITR 422 (SC) – redemption is sale by shareholder i.e., purchase by the Company

Buyback – Income-tax

❑ GAAR implications :

- Commercial substance?
- Rule 10U – GAAR Grandfathering – transfer of investment made prior to April 1, 2017
- S. 115QA levies an additional income tax. The definition of the tax benefit under Rule 10U(3)(iv) refers to saving of 'tax'. 'Tax' is defined u/s 2(43) of the IT Act to mean income tax and does not include additional income tax.

❑ GAAR consequences

- Deem the buyback at fair value instead of nominal value?
 - Section 98 - consequence of invoking GAAR is an inclusive definition but only empowers the tax officer to disregard or re-characterize the transaction or to reallocate the accrual of income among the parties. Section 98 does not empower the tax officer to deem the fair value as the accrual of income (fair value of shares as buy back price)
- 50CA in the hands of shareholders? – can recharacterize as a sale or transfer

Buyback - Advantages

- ❑ Flexibility
 - No prescribed valuation rules

- ❑ Tax on Company and not on the shareholders
 - Tax linked to issue price i.e., what was received by the Company and not the cost in the hands of the shareholders

- ❑ After S. 50CA, one of the only avenue available to restructure – exemption – S. 10(34A)

- ❑ Use of buyback in lieu of dividend?
 - Effective rate – 18.9% v. dividend – 35.9% (highest slab)

Buyback - FEMA

- Buyback from resident shareholders – not applicable
- Buyback from non-resident shareholders - to be done at fair value or lower than fair value - No RBI Approval is required

Capital Reduction

Capital Reduction – Company Law

- ❑ Special Resolution and NCLT approval required (S. 66 of Co's Act, 2013)

- ❑ Capital reduction at NIL consideration?
 - Permissible under Section 66 of the Companies Act, 2013?
 - S. 66 of Companies Act – *company . . . may . . . reduce the share capital in any manner . . .*
 - ACG Arts & Properties (Mum. NCLT); V.M. Salgaocar & Brother (Mum NCLT); O3 Capital Global Advisory (Bang. NCLT) – Favour
 - Ansa Decoglass Pvt Ltd (Mum. NCLT) – Against

Capital Reduction – Company Law & FEMA

❑ Selective capital reduction?

- Brillio Technologies Pvt. Ltd. – Delhi NCLAT – C.A. (AT) No. 293 of 2019 dated April 19, 2021
- Tamanna Hotels Private Limited - C.P No. 1995 of 2018 dated October 22, 2019

❑ Minority Squeeze Out

- Voluntary – Scheme u/s 230(11) and (12)
- Forceful – Have to resort to S. 66

❑ Reduction of capital effected through any scheme u/s 230 – Expln. to S. 230

❑ FEMA

- Resident shareholders – not applicable
- Capital reduction is a unilateral act of the Company – no transfer by non-resident shareholders
 - However, advisable to comply with pricing guidelines
 - Approval of RBI ?

Capital Reduction – Income-tax

With consideration

- ❑ Deemed dividend u/s 2(22)(d) to the extent of accumulated profits
- ❑ Transfer chargeable to capital gains in the hands of shareholders - Kartikeya V. Sarabhai v. CIT [1997] 228 ITR 163 (SC)
- ❑ Capital Gain net off amount charged as dividend – CIT v. Surat Cotton Spg. & Wvg. Mills (P.) Ltd. [1993] 202 ITR 932 (Bombay HC)

Without consideration

- ❑ S. 45 & 48 – No consideration – computation mechanism fails – No capital gains tax
 - Bennett Coleman & Co. Ltd. v. ACIT [2011] 12 ITR(T) 97 (Mumbai T SB) – Bombay High Court appeal admitted

Capital Reduction – Income-tax

- ❑ S. 50CA applicable / not applicable ?
- ❑ S. 56(2)(x) – no receipt of shares by the company
- ❑ S. 115QA?
 - Not applicable – capital reduction is cancellation of shares and not purchase by Company
- ❑ Transfer Pricing
 - Capital reduction is a unilateral act of the Company – not a transaction
 - Approval of the shareholder ?

Loan Waiver

Loan Waiver – Income Tax

In the hands of borrower:

❑ Section 28(iv) – benefit or perquisite?

- Receipt of money – not receipt in kind - Commissioner v. Mahindra and Mahindra Ltd. [2018] 93 taxmann.com 32 (SC) - not taxable u/s 28(iv)

❑ Section 41(1) – cessation of trading liability?

- Waiver of loan taken for acquiring capital assets - Commissioner v. Mahindra and Mahindra Ltd. [2018] 93 taxmann.com 32 (SC) - not taxable u/s 41(1)
- Waiver of loan taken for trading activity – CIT v. Compaq Electric Ltd. [2019] 101 taxmann.com 400 (SC) (SLP dismissed on merits)
- Assessee purchased (at less than issue price) its own bonds and extinguished them, profit gained in buy-back process could not be taxable u/s 41(1) as assessee had not claimed deduction of trading liability in any earlier year – CIT v. Reliance Industries Ltd. [2019] 102 taxmann.com 142 (Bombay HC)

Loan Waiver – Income Tax

- ❑ 56(2)(x) applicable in the hands of borrower?
 - No constructive receipt
 - Implications of SC ruling in CIT v Mahindra & Mahindra [[2018] 404 ITR 1 (SC)] categorically holding that waiver amounts to capital ‘receipt’
 - Receipt of a benefit v. receipt of a thing (property)
 - Waiver of loan is not a property

In the hands of lender:

- ❑ Bank – bad debts u/s 36(1)(vii)
- ❑ Group Company – business loss ?
 - CIT v. Cable Corporation of India Ltd. [2016] 75 taxmann.com 117 (Bombay HC)
 - CIT v. Spencers and Co. Ltd. [2013] 359 ITR 612 (Madras HC)

Loan Waiver – Income Tax

❑ Waiver of past interest:

- In the hands of Lender – allowed as a deduction u/s 36(1)(vii)
- In the hands of borrower – S. 41(1) will apply
 - If loan taken from bank, NBFC:
 - No interest claimed earlier u/s. 43B since no payment – No addition u/s. 41(1) - ACIT v. Spel Semiconductor Ltd. [2013] 35 taxmann.com 304 (Chennai - Trib.)
 - If loan taken from group company - If interest not claimed as expense in earlier years – no addition u/s. 41(1):
 - ACIT v. Spel Semiconductor Ltd. [2013] 35 taxmann.com 304 (Chennai - Trib.)
 - Fertilizer Corporation of India Ltd. v. ACIT [2019] 69 ITR(T) 183 (Del. Trib.)

Loan Waiver – Income Tax

❑ Waiver of future interest:

- In the hands of lender – No interest accrued on account of change in terms of loan agreement – No interest income chargeable to tax:
 - CIT v. Shoorji Vallabhdas & Co. [1962] 46 ITR 144 (SC)
 - CIT v. Birla Gwalior (P.) Ltd. [1973] 89 ITR 266 (SC)
- In the hands of borrower – No interest payable – No expense allowable as expenditure

Servicing of securities

Interest, dividend

Income Tax – Interest Expense

- ❑ Interest on loans taken from following parties allowable u/s. 43B of the Act on payment basis:
 - Public financial institution; State Financial Corporation or State Industrial investment corporation
 - Deposit taking NBFC or systemically important non-deposit taking NBFC
 - Scheduled bank or Cooperative bank (other than primary agricultural credit society or primary co-operative agricultural and rural development bank)

- ❑ Interest on other loans allowed on mercantile basis provided borrowing is for the purpose of business (– S. 36(1)(iii))
 - Invest in share of subsidiary / Interest Free Loan to group entity out of borrowed funds – commercial expediency test – S.A. Builders Ltd. v. CIT(A) [2007] 288 ITR 1 (SC)
 - For reconsideration – ACIT v. Tulip Star Hotels Ltd. [2012] 21 taxmann.com 97 (SC)
 - Investment in shares – business - CIT v. Rajeeva Lochan Kanoria (208 ITR 616) (Cal HC); CIT v. Srishti Securities (P.) Ltd. (321 ITR 498) (Bombay HC)

- ❑ Taparia Tools Ltd. v. JCIT [2015] 372 ITR 605 (SC) – bullet payment of interest at inception of the debt instrument for 5 years – entire amount allowed in year 1.

- ❑ Madaras Industrial Corporation v. CIT [1997] 255 ITR 802 (SC) – Discount on issue of debenture to be amortised over the tenure of debenture

Income Tax – Interest & Dividend Income

□ DTAA

- Controversy of beneficial ownership – SPV
- MFN Clause
 - Circular No. 3/2022 Dated 3-2-2022
 - Cotecna Inspection SA v. ITO [2022] 136 taxmann.com 368 (Delhi HC)

□ Zero Coupon Debenture –

- Taxable on maturity v. year on year
 - DIT v. Credit Suisse First Boston (Cyprus) Ltd. [2013] 351 ITR 323 (Bombay HC) When an instrument or an agreement stipulates interest to be payable at a specified date, interest does not accrue to holder thereof on any date prior thereto.
- Interest v. Capital Gain
 - Definition of interest u/s S. 2(28A) is wide and an inclusive definition
 - Lomax (Inspector of Taxes) v. Peter Dixon & Son Ltd. [1944] 12 ITR 1 (CA)(SUPP.) Court of Appeal substance of the transaction – Instrument does not carry any interest, discount or premium would be normally, be regarded as interest
 - ICDS 4 on revenue recognition. provides similar treatment to interest, discount and premium i.e. to be recognised as revenue as if it were accruing over the period to maturity.

Conversion of Securities

Conversion of Securities – Company Law

- ❑ S. 62(3) – Section 62 to not apply if:
 - There is a **prior agreement** for conversion of loan into shares
 - Such agreement has been approved by a **special resolution**
 - Special resolution not passed at the time of acceptance of loan – Raj Singh Chopra v. Jagat Singh Chopra [2018] 90 taxmann.com 156 (NCL-AT) – loan cannot be converted
 - Convert old loan into new convertible loan?

- ❑ Shares can be issued under S. 62(1)(c) – off-set the loan payable
 - Circular 8/32(75) 77 – CL/V (Company Law Department) Dated March 13, 1978
 - R. Spargo's Case 1873 8. Ch A. 407

Conversion of Securities – Income-tax

- ❑ Capital gains on conversion of –
 - CCPS / OCPS / CCD / OCD - Exempt u/s 47(x) (debentures) and 47(xb) (preference shares)
 - Warrants – no transfer – DCIT v. Kemper Holding Pvt. Ltd. [2013] ITA No. 6426/M/2011 (Mum. Trib.)
 - Cost of previous instrument and period of holding of the previous instrument to be considered

- ❑ On conversion of loan - Violation of S. 269T?
 - Book entry - Not a repayment in cash – not a violation
 - CIT v. Adinath Builders (P.) Ltd [2019] 102 taxmann.com 57 (SC) (SLP dismissed)
 - CIT v. Ajitnath Hi-Tech Builders (P.) Ltd. [2018] 92 taxmann.com 228 (Bombay HC)

Conversion of Securities – Income-tax

❑ 56(2)(viib)?

- No constructive receipt
- Allotment for consideration other than cash
- DCIT v. M/s. Rankin Infrastructure Pvt. Ltd (ITA NO. 7288/MUM/2019)

❑ 56(2)(x)?

- Absence of a specific exclusion in the proviso to S. 56 for exempt transfer u/s. 47(x) and 47(xb)
- Upon conversion it is mere working out of pre-existing rights of the holder or mere discharging of obligation by the issuer
- Fair value and consideration at the time of conversion has to be equal – difference in valuation mechanism cannot trigger income

Conversion of Equity into Preference Shares

- ❑ May not be feasible in public companies as compared to private companies

- ❑ Equity shares converted into preference shares
 - Conversion by variation of rights u/s 230 / S. 48
 - 'Class' (S.48 and S. 230) synonymous with 'kind' (S. 43)?
 - Conversion of equity shares into say class A equity share with all the rights of preference shares just not called preference share

 - Can conversion be into irredeemable preference shares – contrary to S. 55(1) of Co. Act?
 - Backdoor route – doing indirectly what you cannot do directly?
 - To be held to be in violation of Co. Act?

Conversion of Equity into Preference Shares

- Strictly, no penalty under Co. Act on issuance of irredeemable preference shares
- Can the instrument be held to be invalid?
- Gift? Whether other equity shareholders hit by S. 56(2)(x)?
 - Not actual receipt; only constructive receipt
- Capital gains u/s 45 r.w. S 50CA in the hands of shareholder? – exemption u/s 47(xb) is for conversion of preference shares into equity
 - Periar Trading Company (P.) Ltd. v. ITO [2018] 174 ITD 137 (Mum. Trib) - applicable?
- Equity shares converted into debentures
 - Reduction of capital under S 66

Conversion of CCD into OCD

❑ CCD converted to OCD

- 10 year CCDs issued – not deposit as per S. 73 r.w. Rule 2 of Companies (Acceptance of Deposit Rules), 2014
- Subsequently, vary rights and convert CCD to OCD
- Backdoor route – doing indirectly what you cannot do directly?
 - To be held to be in violation of Co. Act? - Severe punishment – S. 76A of Co. Act
- Conversion of one kind of debenture into another kind – exempt from capital gains u/s 47(x)
- Conversion of one kind of debenture into another kind – no “receipt” – 56(2)(x) not applicable

❑ FEMA

- Not permissible
- Resident can purchase CCD from non-resident and then convert into OCD

Conversion – Other Variation of Rights

❑ Specific Property Rights

- Right to particular immovable property, jewellery, IP, etc.
- CIT v. Shree Nirmal Commercial Ltd. 213 ITR 361 [1995] [Bom HC]

❑ Compartmentalization/ Segmentation

- Protected Cell Companies – Mauritius
 - Income tax does not recognise these cells as separate entities, have to be considered as one
 - Nicholas Applegate South East Asia Fund Ltd. v. ADIT [2009] 117 ITD 299 (TM)
 - Issues under IBC – creditor of Cell A can proceed against whole company and Cell B will also be affected

Conversion – iSAFE

□ India Simple Agreements for Future Equity (iSAFE)

- Concept originated in US – adapted to India
- Standard Agreements – open source
- CCPS
- Useful for Pre-Series A funding round
- No need for valuation – can be converted to fixed equity holding
- Convertible into equity after a fixed timeline or a specified event like entry of a new investor through equity funding

Partnership/ LLP

Partnership & LLP

- Flexibility to be governed by the terms of the LLP agreement
 - The LLP would own the family properties including shares of operating companies.
 - Separation of management & economic reward
 - Preordained succession
 - Perpetual succession is possible
 - Restriction on transfer of interest in LLP
- LLP - Limited Liability Partnership Act, 2008
- S. 23(1) - mutual rights and duties of the partners of a limited liability partnership shall be governed by the limited liability partnership agreement

Admission of Partner

- Cash – No tax consequences
- Capital Asset – S. 45(3) – Book value –
 - LLP – Rule 23 of LLP Rules, 2009 – fair value ?
 - 50C will apply ?
 - DCIT v. M/s Amartara Pvt Ltd [2018] TIOL 125 (Mum T)
- Stock in trade – S. 45(3) will apply ?
 - ITO v. Orchid Griha Nirman (P.) Ltd. [2016] 74 taxmann.com 187 (Kolkata - Trib.)
 - DLF Universal Ltd. v. DCIT [2010] 36 SOT 1 (Delhi Trib.) (SB) – **against**
- 56(2)(x) – consideration not determinable
 - Sunil Siddharthbhai v. CIT [1985] 156 ITR 509 (SC);
 - CIT v. Marudhar Hotel (P.) Ltd. [2004] 269 ITR 310 (Rajasthan HC)

Retirement of Partner / Reconstitution of Firm

Post Finance Act 2021 w.e.f. April 1, 2021

- ❑ Section 9B - charges withdrawal of both Capital Asset and S-I-T
 - Capital Asset - Computation similar to erstwhile S 45(4) – based on FMV charge as LTCG or STCG
 - S-I-T - New charge

- ❑ Charge Receipts by Partner (in form of money or capital asset) on reconstitution over and above capital balance – **New Sec 45(4)**
 - Charge as capital gains - LTCG or STCG – depending appreciation in assets of partnership
 - Taxation of appreciation attributable to stock in trade ?
 - Effectively charge profits of Partner in hands of the Firm
 - Does not refer to withdrawal of S-I-T
 - Increase in capital balance by revaluation of asset and from self generated goodwill and assets is to be excluded from capital balance

Retirement of Partner / Reconstitution of Firm

- ❑ S. 48(iii) – Mitigate double taxation on **subsequent** transfer of asset which is revalued and charged
 - Cost step-up allowed only for capital assets and not stock-in-trade

- ❑ Reconstitution – defined
 - Retirement of partner
 - Admission of new partner(s) accompanied by continuation of old partner(s)
 - Change in share of partner(s)

Retirement of Partner / Reconstitution of Firm

□ Reconstitution

- Reconstitution 'means' – specific definition – restricted to specified scenarios
- Scenarios not covered
 - only introduction and withdrawal of capital without change in share of profit/loss
 - Change of powers between partners
- Whether only a change in loss sharing ratio is covered ? 'change in share'
- Whether change in remuneration or interest on capital tantamount to reconstitution ?
 - CIT v. R.M. Chidambaram Pillai [1977] 106 ITR 292 (SC) – remuneration to partner regarded as manner of payment of share of profit.
- What if the share of profit/loss is based on ratio of balance in the fixed capital account or current capital account or both ?

Transfer of Interest in Firm/LLP

- Restriction on transfer of interest in LLP/Firm – S. 42 of the LLP Act and S. 29 of the Indian Partnership Act –
 - Transferee or assignee does not have the right to participate in the management or conduct of the activities of the LLP or access information concerning the transactions of the LLP.
 - Only the right to profit or loss in the firm/LLP is transferrable
- Taxation on transfer of interest in partnership (Samir S Sheth v. ACIT – IT A No.2919 & 3092/ Ahd/2002)
 - Cost of Acquisition?
 - Capital contribution; or
 - Not determinable
 - How to compute indexation ?
 - 56(2)(x) – interest in partnership marketable security ?

Thank You