Tax Matters

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The team at JMP Advisors is pleased to bring to you a gist of some of the significant developments in the direct tax space during August 2022:

Income tax rulings

- **Twin conditions in Section 10B of the Income tax Act ('the Act') to be fulfilled to claim relief**

  - Principal Commissioner of Income Tax – III v. Wipro Limited (Supreme Court) (Civil Appeal No. 1449 of 2022)

The taxpayer, a 100 percent export-oriented undertaking, filed its return of income declaring loss and claimed exemption under Section 10B of the Act. The taxpayer had not claimed any carry forward of losses.

Subsequently, the taxpayer filed a declaration to opt-out of the benefit under Section 10B of the Act. The taxpayer filed the revised return of income where the benefit under Section 10B was withdrawn and the taxpayer claimed carry forward of losses.

As regards to the revised return of income under Section 139(5) of the Act, the Hon'ble SC concluded that such revised return can substitute the original return filed under Section 139(1) of the Act and cannot transform into a loss return. The taxpayer can file a revised return in a case where there is omission or wrong statement.

As regards withdrawal of claim under Section 10B(8), the Hon'ble SC held that wording of Section 10B(8) of the Act is unambiguous and for claiming the option for not availing benefits under Section 10B of the Act, the taxpayer must satisfy the following twin conditions:

i. furnish a declaration to the tax officer in writing that the provisions of Section 10B(8) of the Act may not be made applicable to the taxpayer; and
ii. the said declaration must be furnished before the due date of filing of return of income under Section 139(1) of the Act.

The Hon'ble SC also held that exemption provisions are to be strictly and literally complied with and the same cannot be construed as procedural requirement.

JMP Insights – Various HC have interpreted the exemption provisions liberally but SC in this case has interpreted the compliances to the exemption provisions in a strict and literal manner. Taxpayer must take note of this strict interpretation of the provisions and must ensure compliance with the conditions and procedural requirements in a timely manner.

- **Conversion of Compulsorily Convertible Debentures ('CCDs') into equity shares attracts Section 56(2)(viib) of the Act**

  - Milk Mantra Dairy Pvt. Ltd. v. Deputy Commissioner of Income tax (Kolkata Tribunal) (ITA. No.413/KOL/2020)

The issue before the Tribunal was the applicability of Section 56(2)(viib) of the Act on conversion of CCDs into equity shares by closely held companies.

The taxpayer is a private limited company engaged in manufacturing and selling of dairy products. It had issued CCDs during AYs 2011-12 and 2012-13 which had been converted into equity shares during the year under consideration i.e. AY 2013-14. The equity shares were issued at a premium by adopting the Discounted Cash Flow ('DCF') method.

The tax authorities contended that equity shares were issued at a price over and above the Fair Market Value ('FMV'); hence the tax authorities, applying the mechanism provided in Rule 11UA(2)(a) of the Income tax Rules, 1961 ('the Rules'), computed negative FMV, thereby treating the entire consideration to be taxable under Section 56(2)(viib) of the Act.

The taxpayer contended that the entire consideration was received by it at the time of issuance of CCDs. Conversion of CCDs by issuing equity shares did not entail any further payment of money. Thus, the provisions of Section 56(2)(viib) of the Act cannot be applied in the year of allotment of shares. The taxpayer further argued that provisions of Section.56(2)(viib) of the Act cannot be applied in this case, since the said Section was not in existence when the money was received i.e. AYs 2011-12 and 2012-13.

The Tribunal emphasized on the words "*receives any consideration*" contained in Section 56(2)(viib) of the Act and held that the term "consideration" is wider as compared to words "amounts" or "money". Receipt of money is one of the several modes for having a consideration in a transaction. The Tribunal listed down some of the "*considerations*" that the taxpayer "*receives*" on the conversion of its CCDs into equity shares-

a. The debt obligation on the taxpayer to repay is extinguished
b. The charge created on the assets/properties of the taxpayer is released
c. The cost of servicing the debt obligation by paying periodic interest is mitigated
d. The capital based in the form of own funds gets widened to leverage the capital/stock markets
e. The debt-equity ratio of the taxpayer becomes favorable
f. The risk of getting into the claim of insolvency resolution from the debt creditors in case of default in servicing their debt obligation is mitigated

Thus, the conversion of CCDs into equity shares entails receipt of consideration by the assessee which is translated into the total issue price of shares including share premium. Accordingly, the provisions of Section 56(2)(viib) apply in the present case.

Further, the Tribunal held that tax authorities do not have the power to reject the method of valuation adopted by the taxpayer, since the taxpayer has the option to adopt Net Asset

Value ('NAV') or DCF method. The tax authorities can only question the correctness and completeness of the manner in which valuation has been done, based on the scientific basis of valuation and rationality of assumptions adopted by the taxpayer.

***JMP Insights** – In this case, it has been held that the provisions of Section 56(2)(viib) of the Act will be applicable to closely held companies issuing equity shares against conversion of CCDs. The principle laid down can be applied to other hybrid instruments as well and may have wide ramifications.*

Also, the ruling has discussed the importance of documents and supporting evidence to be maintained by the taxpayer in order to explain the assumptions made while deriving the FMV of the shares.

- **Set off of losses disallowed despite HC's approval to demerger since sole underlying purpose was tax-benefit**

  - DCIT v. Cummins Sales & Services (I) Ltd. (Pune Tribunal) (ITA No. 2121/PUN/2017)

Highway Solutions of Cummins Auto Services Ltd, a 100% subsidiary of taxpayer Company was demerged and vested with the taxpayer. The scheme of demerger was approved by Bombay High Court ('HC'). During the year under consideration, the taxpayer had claimed set off of losses and unabsorbed depreciation relating to demerged undertaking against the taxable income as per the provisions of Section 72A(4) of the Act.

The tax authorities disallowed the set off of brought forward losses by concluding that scheme of demerger was not carried out for a genuine business purpose as contemplated under Section 72A (5) of the Act. The Revenue had found that the assets of the demerged undertaking were held for sale which indicated that there was no intention of the taxpayer to continue the business of the demerged undertaking.

The first appellate authority passed a perfunctory order and ruled in favour of the taxpayer on the premise that once the demerger had been approved by the HC, it is not within the jurisdiction of the tax officer to question the motive behind the demerger. The tax officer cannot apply his own guidelines in order to arrive at whether or not the demerger is for a genuine business purpose.

Based on the facts of the case, the Tribunal disallowed the set off of losses and held as under:

- Mere approval of the scheme by the HC does not entitle the taxpayer to claim benefit of the set-off of brought forward business losses. Though the scheme of demerger once approved by the HC cannot be re-visited by statutory authority, the conditions prescribed under the Act need to be complied with.

- Referring to the Memorandum explaining the Provisions of Finance Bill, 1997, the Tribunal noted that the object behind enactment of Section 72A of the Act was revival

of sick units and relieving the Government of uneconomical burden of taking over and running of the sick units and at the same time to save the Government from incurring social costs in terms of loss of production and unemployment.

- Taxpayer did not carry any business of demerged undertaking and held the assets of the demerged unit for sale; the taxpayer clearly did not have any intention of carrying on business of demerged undertaking.

- The fact that the Government has not laid down the criteria for determining the circumstances under which demerger can be said to be for non-genuine purpose, does not alter the position for allowability of the business losses and unabsorbed depreciation.

Thus, placing reliance on various judicial precedents, the Tribunal concluded that set-off of brought forward business losses cannot be allowed when the sole idea behind the scheme was to avail tax benefits.

JMP Insights *– Approval of the scheme by the HC does not give a blanket clearance to the demerger scheme and that the benefits of demerger under the provisions under the Act can be availed only if the conditions under the Act are strictly complied with. Non-specification of conditions under Section 72A(5) of the Act does not absolve the demerger for fulfilling the criteria of being for "genuine business purpose" .*

Notification

➢ **Exclusion from definition of Virtual Digital Asset ('VDA') as per Section 2(47A) of the Act.**

The Central Board of Direct Taxes ('CBDT'), vide Notification No. 74/2022/F.No. 370142/29/2022-TPL (Part-I), dated 30 June 2022, has notified that following VDAs will be excluded from the definition of VDA:

- Gift card or vouchers, being a record that may be used to obtain goods or services or a discount on goods or services;
- Mileage points, reward points or loyalty card, being a record given without direct monetary consideration under an award, reward, benefit, loyalty, incentive, rebate or promotional program that may be used or redeemed only to obtain goods or services or a discount on goods or services;
- Subscription to websites or platforms or application.

The CBDT, vide Notification No. 75/2022 dated 30 June 2022, further notified that while a non-fungible token ('NFT') qualifies to be a VDA within the meaning of Section 2(47A)(a) of the Act, it shall not include a NFT whose transfer results in legally enforceable transfer of ownership of the underlying tangible asset.

The aforesaid notifications will come into force from the date of publication in the official gazette.

DID YOU KNOW?

CBDT has notified various forms, returns, statements, reports, orders which shall be mandatorily furnished electronically and verified in the manner prescribed by CBDT (includes Form 10F, Form 68, etc.)

Should you wish to discuss any of the above issues in detail or understand the applicability to your specific situation, please feel free to reach out to us on coe@jmpadvisors.in.

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