Direct Tax Vista

Your weekly Direct Tax recap

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1. New Angel Tax Rules to provide a mechanism to evaluate the shares issued by unlisted startups to non-resident investors and more

The Finance Act, 2023, brought in an amendment to bring the consideration received from non-residents for issue of shares by an unlisted company within the ambit of section 56(2)(viib) of the Income-tax Act, which provides that if such consideration for issue of shares exceeds the Fair Market Value (FMV) of the shares, it shall be chargeable to income-tax under the head 'Income from other sources'. The logic behind application of this angel tax to NRIs had been cited as to prevent generation and circulation of unaccounted money through share premium received from NRI investors in a closely held company (CHC) in excess of its fair market value. However, it was considered difficult to convince field officers about the valuation of start-ups or even new enterprises with good business prospects. This could have an impact on the growth of start-ups and new enterprises in India, which would have gone against the Government's broad focus.

The CBDT thus announced certain amendments to valuation rules (i.e., Rule 11UA) vide Press Release dated 19 May 2023 and issued draft of amended Rule 11UA for public comments on 26 May 2023.

Further, vide Notification No. 29/2023 dated 24th May, three categories of entities were notified to have been retrospectively exempted from Sec 56(viib) since 1st April 2023. These were those entities which were registered with Sebi as Category-I FPI, Endowment Funds, Pension Funds and broad-based pooled investment vehicles, which are residents of 21 specified nations, including the US, UK, Australia, Germany and Spain. Important is that top jurisdictions like Singapore, Mauritius and

UAE are excluded from the specified nations list - these three countries together constitute over 50% FDI in India. Furthermore, Notification No. 30/2023 exempted start-ups companies from the angel tax provision if the start-up company fulfils the conditions specified by DPIIT in para 4 of its Notification No. G.S.R 127(E) dated 19 February 2019 and files a self-declaration to that effect. The exemption was applicable where a start-up company issue shares for a consideration at a premium to any person (whether resident or non-resident). The said Notification came into force retrospectively from 1 April 2023. It superseded the earlier CBDT Notification No. 13/2019 which granted similar exemption to start-ups for issue of shares to resident investors.

With already so much water under the bridge, now the CBDT has notified the final amended Rule 11UA vide Notification No. 81/2023 dated 25th September, 2023. The salient features of the amended Rule 11UA are as under:

- The most important aspect is that the amended Rule 11UA introduces safe harbor limit of 10% for valuation of equity shares and compulsorily convertible preference shares (CCPS) for both resident and NR investments. This will reduce the burden of Angel Tax on startups and other CHCs that receive investments from angel investors and venture capitalists.

- The amended Rule 11UA provides separate valuation mechanism for CCPS and also provides an option to adopt fair market value (FMV) of unquoted equity shares for determining FMV of CCPS.

- The erstwhile Rule 11UA prescribed two methods (viz. NAV or DCF) for determining the FMV of equity shares issued to resident investors. The amended Rule 11UA provides five new methods of valuation for issue of unquoted equity shares or CCPS to NR investors viz. Comparable Company Multiple Method, Probability Weighted Expected Return Method, Option Pricing Method, Milestone Analysis Method and Replacement Cost Methods. These methods are exclusively applicable for determining the FMV of shares issued to non-resident investors.

- However, on the field new questions arise. Thus a question arose as to whether in case the assessee opts for determination of the fair market value of the shares by opting for any of the methods prescribed under rules, then can the AO reject that method itself? Or should the AO only limit himself to scrutinizing the valuation report within the conditions or parameters laid down in the method chosen by the assessee? This was answered in the case of Innoviti Payment Solutions Pvt. Ltd. Vs. ITO reported in (2019) 102 taxmann.com 59 (Bangalore Trib) wherein the co-ordinate Bench of the Tribunal held that the method adopted by the assessee has to be accepted by the AO. The AO can of-course point out any defect in the implementation of the valuation method. The same was also held in the case of THE DEPUTY COMMISSIONER OF INCOME TAX, CIRCLE 16(1), HYDERABAD Vs M/s NCL GREEN HABITATS PRIVATE LIMITED [2023-VIL-717-ITAT-HYD].

- The price matching facility, for equity and CCPS, provides that the price at which unquoted equity shares or CCPS are issued by CHC to notified NR entities/ venture capital funds (VCF)/ specified funds shall be adopted as FMV for the purposes of benchmarking equity and CCPS investments by both resident and NR investors, subject to compliance of certain conditions. However, the CHC must receive consideration from the notified entity within 90 days before or after issuing the shares in question.

- The erstwhile Rule 11UA required merchant banker DCF valuation report as on the date of issue of shares. Now the valuation report by the Merchant Banker would be acceptable if it is of a date not more than 90 days prior to the date of issue of shares

- The rules are applicable to all cases of issue of unquoted equity shares on or after September 25, 2023.

2. Apex Court lays down the process of applying to Settlement Commission in Income Tax Cases

When applying to the settlement commission, the question arises whether an application can be made before the settlement commission for disclosing an income

which had escaped assessment and which was already discovered by the AO while finalising assessment; on whether the immunity from prosecution or penalty proceedings is available to the appellant only on co-operation with the settlement commission as per Section 245H of Income Tax Act or the appellant has to prove that there was '*no concealment or wilful neglect on its part*'. Would The Settlement Commission have to examine the application by lifting the veil to see as to whether there has been an intention to evade tax and then arrive at a conclusion?

Section 245C (1) provides that "*An assessee may, at any stage of a case relating to him, make an application in such form and in such manner as may be prescribed, and containing a full and true disclosure of his income which has not been disclosed before the Assessing Officer, the manner in which such income has been derived, the additional amount of income-tax payable on such income and such other particulars as may be prescribed, to the Settlement Commission to have the case settled* ..."

Hence, incase a strict interpretation of the above Section is done, then it can be interpreted that unless there is a true and full disclosure, there would be no valid application and the Settlement Commission will not be able to assume jurisdiction to proceed with the admission of the application. However, it must be noted that the very object and intent of Chapter XIXA was to settle cases and to reduce the disputes and not to prolong litigation. But the provisions of Chapter XIX-A of the Act, should also not be used provide a shelter for tax dodgers, to subsequently obtain immunity from facing the consequences of tax evasion by simply approaching the Settlement Commission.

There is a difference between the provisions of Section 245H and Section 271(1)(c) of the Income Tax Act. Section 245H does not contemplate offering of any explanation or evidence by an applicant to the satisfaction of the Settlement Commission. If the Settlement Commission is satisfied that an applicant has complied with the precondition specified therein, it could exercise its discretion to grant immunity from prosecution and penalty. The Settlement Commission is the sole judge of the adequacy of and the nature of evidence placed before it and so

long as cogent material and explanation is furnished by the appellant-assessee, it can grant relief. It the Settlement Commission is convinced that the appellant-assessee has co-operated with the Settlement Commission in the proceedings before it and has made a full and true disclosure of its income and the manner in which such income has been derived, it may grant immunity from prosecution or from the imposition of penalty. The same was held in the case of KOTAK MAHINDRA BANK LIMITED Vs COMMISSIONER OF INCOME TAX BANGALORE [2023-VIL-25-SC-DT].

Hence, to sum up, the Order passed by Assessing Officer based on any discovery made is not final. The assessee may accept the liability, in whole or in part, as determined in the assessment order. In such a case, the assessee may approach the Settlement Commission making 'full and true disclosure' of his income and the manner in which such income has been derived. Such a disclosure may also include the income discovered by the Assessing Officer. While exercising power under Section 245H, read with Section 245C of the Act the relevant facts and material which ought to be considered by the Commission are:

i. the report which is to be submitted by the Commissioner, under Section 245D(1) of the Act;
ii. the disclosures made by the applicant before the Commission as to income, and the source of such income;
iii. any other relevant evidence let in by the assessee or the department.

3. AO has to record satisfaction that disallowance made by assessee u/s 14A r.w. Rule 8D is not correct

Section 14A(2) of The Income tax Act requires that The AO shall determine the amount of expenditure incurred in relation to such exempt income in accordance with Rule 8D, if the AO, having regard to the accounts of the assessee, is not satisfied with the correctness of the claim of the assessee in respect of such expenditure in relation to such income which does not form part of the total income under this Act. However, The AO has to objectively record his satisfaction, as to why the suo moto disallowance made by the assessee u/s 14A of The Income Tax Act is

incorrect. Incase it is not done, then the disallowance made by merely applying the computation mechanism provided in Rule 8D(2) of the Income Tax Rules deserves to be deleted in view of the decision of Hon'ble Supreme Court in the case of Maxopp Investment Ltd. vs. CIT reported in 402 ITR 640 (SC). The same was upheld even incase of M/s SUDHIR POWER LIMITED Vs DY. CIT [2023-VIL-1256-ITAT-DEL].

4. Expenditure on educational seminars by 'Charitable Institutions' related to the main object cannot be disallowed

'Chintan Shivirs' for exchange of knowledge is not new and, without going too much in the political landscape, specially it is not new to the current Government in India. Organizing such seminars, conference and lectures provide a platform and environment for exchange of knowledge experience upgrade the knowledge about the latest development in the area of teachings, equipped with skill and practical knowledge for both teachers and students. It also facilitates the development of understanding between the participants like teachers and students for free flow of knowledge and ideas. Hence, where the main object of the assesse is that of imparting/improving education, such expenditure cannot be considered as not related to the object. The same was held in the case of SARSWATI VIDHYA PRATISHTHAN M.P Vs DCIT (E) BHOPAL [2023-VIL-1262-ITAT-IND]. Similar can a be a case of an assessee with a main object u/s 11 of Income Tax Act as that of promotion of scientific development (Engineering Institutes), Promotion of protection of trade & Commerce (Chambers of Commerce), promotion of real estate (Institutions like CREDAI), Promotion of Management Studies (Management Institutes), etc.

However, what these organisations have may have to look into are the observations of The Hon'ble Apex Court declaring that specific incomes themselves may or may not be exempt in the case of trusts; in the back-to-back judgements 2nd half of 2022, in the case of Ahmedabad Urban Development Authority and New Noble Education Society. In simple words, the entities claiming exemption u/s 11 of The Income Tax Act have to prove the following –

A. That there is no standalone activity in the nature of on trade, commerce or business. If that be so, then separate books of accounts be maintained and the profits be offered for tax.

B. In the course of advancing the object of GPU, the entity can carry on 'connected' activities in the nature of trade, commerce or business. But, the receipts from these activities should not be more than 20% of the total receipts. The consideration for such connected activities should also be on cost-basis or nominally above cost. How much above cost is not mentioned. But, it is a fact that 15% accumulation is officially allowed by The income tax Act and possibly that could be a benchmark.

5. CBDT notifies classification of NBFCs into top, upper and middle layers

Section 43B(da) of The Income Tax Act provides that any interest payable on the loan taken from a Deposit-taking NBFC or a Systematically Important Non-deposit-taking NBFC shall be allowed as a deduction only when the payment is made. Further Section 43D of the of the Income Tax Act, 1961 (the Act) provides for the taxation of the interest income in relation to bad or doubtful debts in case of public financial institution, banks, public company etc.

Only two classes of NBFCs were included earlier, i.e. Deposit-taking NBFCs and Systemically Important Non-Deposit-taking NBFCs. The RBI no longer follows such two classifications for NBFCs. Hence the CBDT has now borrowed the criteria for classification as provided by the guidelines set forth in Circular DOR.CRE.REC.No.60/03.10.001/2021-22, dated October 22, 2021. Notification No. 79/2023 & 80/2023 specify that the categorization of NBFCs, based on layers determined by RBI guidelines, will be applicable for income tax assessment from 22nd September 2023. These are all NBFCs classified in the Top Layer; Upper Layer; and Middle Layer.

6. Differential Cash from sale of property once banked will be considered as an explanation... incase evidences are maintained

Cash exchanges in a property deal have been reduced by multifarious amendments in the Income tax Act. Now the position is that the stamp duty value is more often

higher than the deal value itself. However, incase the parties do exchange cash as sale consideration over and above the registered deal value and the seller deposits all the excess cash in the bank, then sufficient evidences may be maintained by the seller to indicate that there were exchange of cash between the parties prior to the execution of a registered sale deed. Under such circumstances, the seller's explanation of the source of cash will be entitled to be accepted. The ratio was laid by The ITAT Amritsar in the case of SH. HARBANS SINGH Vs INCOME TAX OFFICER [2023-VIL-1240-ITAT-ART] and may held in property deals.

7. High Seas transactions cannot be created as a facade to hoodwink the Revenue

In a High Seas transaction, the agreement should be entered on a stamp paper. After dispatch from the port of origin and before delivery at the port of destination, the bill of lading should be endorsed in the name of the new buyer. The endorsement should mention that the goods are being transferred on high seas basis and the amount of goods should also be mentioned. Where the purchases are shown and also the sale is shown on the same day itself at a much lower price, that too to a related entity, it would certainly be considered that an intermediary company has been created for this purpose and would be doubted by the department as a transaction which is arranged in order to create a facade to hoodwink the Revenue. Further there cannot be a difference between a sale and purchase invoice incase of a high seas sale too. Incase these are there, then these would be considered as incriminating material and in the absence of other evidences this is a fit case for bogus purchase and sale and the same has been held in the case of M/s IMPERIAL MARK TRADE Vs DY. CIT, C.C.-7(2) [2023-VIL-1241-ITAT-MUM]

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