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By

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Dear Readers,

Greetings for the season!

In this edition, we bring to you certain important articles on various aspects.

The article on 'Angel Tax – Genesis, Problem, Relief, Conclusion & Way Forward' deals with the acute problem that is faced by the Start-up segment from the income tax perspective. In the said article, we have laid down the problem, the relief given by Ministry of Commerce & Industry along with Central Board of Direct Taxes, the conclusion as to who is eligible for such a relief and the way forward for other start-ups which are not eligible for the relief provided. I am glad to share the said article is also published on FTAPPCI Journal.

The next article is on 'Interesting Issues – CSR Expenditure' deals with certain issues pertaining to interpretation of Explanation 2 to Section 37(1) of Income Tax Act. The main issue is whether such explanation is prospective or retrospective and whether such explanation would apply in situations where CSR Expenditure is voluntarily contributed. Hope you have good insights reading said article.

The next article is on 'Interest Payable – Whether Compensatory or Complimentary to Revenue?' under GST laws deals with the analysis of Standing Order of Hyderabad Principal Commissioner, wherein it was stated that interest is payable on gross tax liability despite of the fact that entire/part of such liability can be settled using accumulated input tax credit. My team has made an attempt to see whether such interest is payable or not on portion of accumulated input tax credit in light of Standing Order.

The next article is on 'Quality Audit Reports – Inform and Influence' deals with significance, objectivity and attributes of effective audit report. The reporting is an important process and we have tried to capture the essential elements required for drafting an audit report.

I hope that you will have good time reading this edition and please do share your feedback. I will also urge clients to mail us topics or issues on which you want us to deliberate in our future editions, so that we can contribute to the same.

Thanking You,

SANNAREDDY SURESH BABU

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INCOME TAX

ANGEL TAX

Contributed by CA Suresh Babu S & CA Sri Harsha

Genesis:

Finance Act, 2012 with effect from 01.04.2013 has introduced a new sub-section to Section 56 (2) of Income Tax Act, 1961 (for brevity 'Act'). The new sub-section (viib) taxes any amount which is received by a company from any person who is resident, any consideration for issuance of shares that exceeds the face value of shares, the aggregate consideration received for such shares as exceeds the fair market value (for brevity 'FMV') of the shares. Section 56(2)(viib) will apply to such companies in which public are not substantially interested.

Further, the said section does not apply, where consideration for issue of shares is received:

- by a venture capital undertaking from a venture capital company/firm[1]
- by a company or class of classes of persons as may be notified by Central Government

The intention of the legislature to introduce Section 56(2)(viib) is to prevent generation and circulation of unaccounted money, which comes into the companies through share capital. The tax authorities tried to tax such consideration which is in excess of FMV of shares vide Section 68 of Act. While they were not successful, a new section namely Section 56(2)(viib) has been introduced to tax such high premiums.

However, the introduction of such section has brought huge problems for 'start-up'. It is common that majority of the investments happen in 'start-up' would be at high premiums because the investor sees what no one else can see. Since Section 56(2)(viib) charges amounts which are in excess of FMV, the 'start-up' community was demanded to pay huge taxes on the premiums received from investors.

Determination of FMV:

Hence, it important to determine the FMV to see whether there is any excess consideration than the FMV of shares as on the date of issue of shares. The said section lays down the method to determine the FMV of shares as under:

- as prescribed in rules[2] or
- as may be substantiated by company to satisfaction of officer, based on the value, on the date of issue of shares, of its assets, including intangible assets being goodwill, know how, patents, copyrights, trademarks, licenses, franchises or any other business or commercial rights of similar nature whichever is higher

[1] VC undertaking, VC company, VC fund as defined in Explanation to Section 10(23FB).
[2] Rule 11 UA of Income Tax Rules, 1962

Rule 11 UA(2) provides two options for the assesse to choose, which are as under:

- Book Value (BV)
- Discounted Free Cash Flow (DCF)

The book value is arrived by subtracting the liabilities from the assets and dividing by number of equity shares in the company. In other words, the BV method looks at the current assets and liabilities of the company to arrive the FMV of share.

On the other hand, the DCF method looks at future cash flows to the company which are discounted at an appropriate discount rate to arrive at the present value of future cash flows. Such cash flows after making certain adjustments are divided by number of equity shares of the company to arrive the FMV of share.

From the above, it is evident that FMV as per BV is current value and FMV as per DCF is the present value of future cash flows. No 'start-up' would choose to value itself under BV method, since substantial assets like research & development and others which can yield potential revenues are not being recognized in the balance sheets as they do not satisfy the definition of 'asset' as per the relevant accounting standards. Hence, the book value would not truly represent the value of company. This leaves the 'start-up' to adopt the DCF method, which is futuristic and not based on today's assets and liabilities.

Ignoring the basic purpose and intent of introduction of Section 56(2)(viib), the tax authorities have made huge demands on 'start-up' for the share consideration received from investors. They have routinely discarded the valuations which are based on DCF method despite of the fact that the said reports are certified by chartered accountants and merchant bankers. The tax authorities have tried to value the company based on BV and proposed demands on the excess of FMV as determined by BV method.

In this article, we attempt to define the problem, the relief, the conclusion and the way forward.

The Problem:

For example, consider a company ABC Private Limited. It has shares of face value Rs 10/-. ABC Private Limited is engaged in development of innovative services. ABC Private Limited was burning cash heavily since majority of the expenditure is pumped into research & development. ABC Private Limited is approached by investor who wants to invest seeing the future of the product which is being developed by ABC Private Limited. Accordingly, after several rounds of negotiation, the value of share is fixed at Rs 350/- per share and investor pumped in funds at such value.

ABC Private Limited has issued 1,00,000 shares at Rs 350/- per share to the Investor. Immediately, the tax authorities propose a demand under Section 56(2)(viib) stating that ABC Private Limited has received consideration for issuance of shares which is more than FMV of shares say Rs 50/- as per BV method. Accordingly, a tax demand was made to the extent of Rs 3 Crores (1,00,000 shares * (350-50) per share).

Now ABC Private Limited has to approach the tax authorities and justify the value of shares as Rs 350/- and not Rs 50/- as proposed by authorities. This will take a good enough time and ABC Private Limited instead of spending time in innovation spends time at Tribunals and Courts to deal with this matter.

This is the acute problem faced by every 'start-up' in India which received consideration from the investor. Investor would not leave a single stone unturned to see that he is not paying more than what the share is worth of. The general ideology of the investor is to invest into the company when it is in young stage and exit when it is in growth stage. Hence, he would not invest more than what the company is worth of. The tax authorities keeping aside all these, propose to tax such excess consideration in the hands of the company who is receiving the monies for issuance of shares.

The Relief:

Central Board of Direct Taxes (for brevity 'CBDT') after examining certain demands raised by tax authorities on 'start-up' community has issued a Circular vide F No 173/14/2018 – ITA dated 6th Feb 2018. The said circular stated that if the assessee is a 'start-up' which falls under the definition given in Notification of DIPP, Ministry of Commerce & Industry, in GSR 501 (E) dated 23.05.2017, the additions made by assessing officer rejecting the valuation provided by 'start-up', no coercive measure is to be taken to recover the outstanding demand.

It is important to note that the relief given by CBDT does not apply to all start-ups. The relief will be applicable to such 'start-up' which would fit into the definition provided by Ministry of Commerce & Industry. The said Ministry has issued various notifications dealing with definition of 'start-up' from time to time. The various definitions including the current one is discussed as under.

Understanding 'Start-Up'

The Ministry of Commerce & Industry has issued the following notifications dealing with 'Start-Up' as on date:

S No	Notification Number	Date of Notification	Current Status
1	GSR 108 (E)	17.02.2016	Superseded
2	GSR 501 (E)	23.05.2017	Superseded
3	GSR 364 (E)	11.04.2018	Superseded
4	GSR 34 (E)	16.01.2019	Superseded
5	GSR 127 (E)	19.02.2019	Active

For the purposes of this article, let us understand the recognition criteria for a company to be called as 'start-up' in terms of Notification No GSR 127 (E) dated 19.02.2019.

Definition of Start-Up:

An entity shall be considered as a 'start-up':

- Upto 10 years from date of incorporation/registration[3]
- Turnover[4] of entity for financial years since incorporation has not exceeded INR 100 Crores
- Entity is working towards innovation, development or improvement of product or processes or services, or if it is scalable business model with a high potential of employment generation or wealth creation

An entity ceases to be 'start-up' once it completes 10 years or turnover exceeds INR 100 Crores. Eligible 'start-up' should make an application and submit relevant documents to get recognized under this Notification.

Relief from Section 56(2)(viib):

A start-up shall be eligible for exclusion from the provisions of Section 56(2)(viib) by issue of notification by CBDT, only if it fulfils the following conditions:

- Such start-up is recognized under this Notification or earlier notifications issued by Ministry
- ***Aggregate amount of paid up share capital and share premium*** of the start-up after issue or proposed issue of share, if any, ***does not exceed Rs 25 Crores and***
- It has not invested in specified assets

Let us proceed to understand in detail the above conditions to evaluate the relief from Section 56(2)(viib).

Exclusions for arriving INR 25 Crores:

One of the conditions to claim exemption from Section 56(2)(viib) is that the aggregate amount of paid up share capital and share premium of the start-up after issued or proposed issue does not exceed Rs 25 Crores.

In order to arrive the said amount of Rs 25 Crores, the notification excludes teh amount of paid up share capital and share premium in respect of shares issued to the following persons:

- non-resident
- venture capital company or venture capital fund
- specified company[5]

[3]Incorporation/Formation is permitted only in nature of Private Limited Company/LLP/Firm

[4]As defined in Section 2(91) of Companies Act, 2013

[5]Specified company means company whose shares are frequently traded within the meaning of SEBI (SAST) Regulations, 2011 and whose net worth on the last date of FY preceding the year in which shares are issued to them exceeds Rs 100 Crores or turnover exceeds Rs 250 Crores.

Investments in Specified Assets:

One of the conditions to claim exemption from Section 56(2)(viib) is that such start-up should not invest in following assets for a period 7 years from the end of latest financial year in which shares are issued at premium:

- Building or land appurtenant thereto, being residential house other than that used by Startup for purposes of renting or held by it as stock-in-trade, in the ordinary course of business
- Land or building or both, not being a residential house other than that used by Startup for its business or used by it for purposes of renting or held by it as stock-in-trade, in the ordinary course of business
- Loans and advances, other than loans and advances extended in the ordinary course of business by the Start Up where the lending of money is substantial part of its business
- Capital contribution made to any other entity
- Shares and securities
- Motor vehicle, aircraft, yacht or any other mode of transport, the actual cost of which exceeds Rs 10 lakhs other than that held by the Startup for the purpose of plying, hiring, leasing or as stock-in-trade, in the ordinary course of business
- Jewellery other than that held by the Startup as stock-in-trade in the ordinary course of business
- Any other asset, whether in nature of capital asset or otherwise, of the nature of archaeological collections, drawings, paintings, sculptures, any work of art or bullion.

If Start-up is found to invest within a period of 7 years from the date of issue of shares at premium, the exemption under Section 56(2)(viib) will be revoked with retrospective effect.

The Conclusion:

From the above, it is evident that both CBDT and Ministry were consistently putting efforts to strike a balance between the start-up eco system and tax revenues. The start-ups accepting consideration towards issue of shares has to examine the relevant conditions are not violated so that they are not burdened with the tax demands.

Further, for companies other than start – ups which are not fitting into the notification and thereby not recognised by Ministry will continue to face challenges from the tax authorities. The blanket rejection of valuation adopted by merchant bankers or chartered accountants[6] by the tax authorities is unwarranted and does hamper the young companies. Since Section 56(2)(viib) is only applicable to resident investors, the companies who are seeking investment are looking towards non-residents to avoid the unnecessary clutches of this provision.

It is also important to note that merchant bankers who are issuing the valuation certificates based on DCF has to adopt the principles of International Valuation Standards to pass the test of the tax authorities. The Mumbai Income Tax Appellate Tribunal in the matter of Madhurima International Private Limited[7] has held that Assessing Officer has failed to examine the valuation report which was issued by Chartered Accountant which does not comply with the minimum standards prescribed by Institute of Chartered Accountants of India and held that action of Commissioner under Section 263 of Act is justifiable.

In addition to the above, the tax authorities have also to bear in mind, the words passed by the Honourable High Court of Bombay in matter of Cadbury India[8] on the aspect of valuation:

7.1.10 Valuation is not an exact science. Far from it. It is always and only an estimation, a best judgment assessment. The fact that a particular estimation might not catch an objector's fancy is no ground to discredit it. All valuations proceed on assumptions. To dislodge a valuation, it must be shown that those assumptions are such as could never have been made, and that they are so patently erroneous that the end result itself could not but be wrong, unfair and unreasonable. The court must not venture into the realm of convoluted analysis, extrapolation, and taking on itself an accounting burden that is no part of its remit or expertise, and no part of a statutory obligation. In particular, the court must guard against the seductiveness of a proposition that suffers from the fallacy of the undistributed middle: all x is z; some y is z; ergo, all y is z. The errors and consequent unreasonableness must be shown to be patent and self-evident

7.1.11 It is impossible to say which of several available valuation models are "best" or most appropriate. In a given case, the CCM method may be more accurate; in another, the DCF model. There are yet others. No valuation is to be disregarded merely because it has used one or the other of various methods. It must be shown that the chosen method of valuation is such as has resulted in an artificially depressed or contrived valuation well below what a fair-minded person may consider reasonable.

Hence, there is abundant necessity on merchant banker or concerned to issue valuation report based on International Valuation Standards and the tax authorities on the other hand should not just reject based on the premise that he is not able to believe the estimate of the value of share. The tax authorities should only reject valuation if the fundamental assumptions used in the valuation report are erroneous and not for the reason that they could not believe that estimate is true.

[6]Prior to removal of 'chartered accountant' from the definition of 'accountant'
[7]2017 (5) TMI 58 – ITAT Mumbai
[8]Company Petition 1072/2009, 1332/2009, 71/2010 and 120/2010

The Way Forward:

The Ministry in the current notification stated that it will revise the notification whenever a need arises on or before 31.03.2021. We hope that out of the experience gained by the Ministry in implementing this notification, the turnover limits or years or aggregate amounts of share capital and premium might be revised upwards to accommodate more genuine start-ups in the ambit of exemption of Section 56(2)(viib). All other start-ups have an inherent duty to see that valuation reports would reflect true picture to avoid the clutches of Section 56(2)(viib). The CBDT has to examine all the matters all over India on this section and issue necessary instruction to assessing officers detailing the procedure to be adopted as to when a valuation report can be rejected and what should be the modus operandi when assessing officer believes that valuation report is erroneous. This will clear the air and reduce the number of start-ups facing the tax burden.

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INCOME TAX

INTERESTING ISSUES - CSR EXPENDITURE

Contributed by CA Ramaprasad T & CA Suresh Babu S

Section 37 of the Income Tax Act, 1961('Act') provides for deduction of revenue expenditure incurred, not being personal expenses and not being those covered by provisions of Section 30 to 36 of the Act, wholly and exclusively for the purpose of the business or profession against income chargeable under the head Profits and Gains from Business or Profession.

Finance Act (No.2) 2014 has inserted Explanation 2 to the Section 37 which provides that any expenditure incurred by the assessee on the activities[1] relating to Corporate Social Responsibility ('CSR') referred to in Sec 135 of the Companies Act, 2013 shall not be deemed to incurred for the purpose of business or profession.

The Explanation is inserted for removal of doubts. The amendment is effective from 01.04.2015 and thereby will apply for the Assessment Year 2015-16. The explanatory memorandum to Finance Act (No.2) 2014 provides that the objective of CSR is to share burden of the government in providing social services by companies having net worth/turnover/profit above a threshold and in case such expenses are allowed for tax purposes it would result in subsidizing, to the extent of tax impact say 1/3, such expenses by the government.

The language of the explanation indicates that the explanation inserted by Finance Act (No.2) 2014 is to clear the doubt or clarificatory in nature, though it was made applicable from Assessment Year 2015-16.

In this article, we made an attempt to discuss on certain interesting Issues arise from the language used while inserting the Explanation 2 to Section 37 of the Act.

Issue #1:

The first issue is whether the explanation has retrospective application, mainly because the same was introduced to remove the doubts. The tax authorities interpret that when an explanation has been introduced to remove the doubts, the said explanation will be deemed to have retrospective application.

The Honourable Delhi Tribunal in the matter of The National Small Industries Corp Limited[2] had an occasion to consider whether the Explanation 2 to Section 37 has a retrospective or prospective application.

The facts of the matter are that the tax authorities have denied expenditure pertaining to CSR activities incurred by The National Small Industries Corp Limited based on the interpretation that Explanation 2 to Section 37 has a retrospective application and also applicable to Assessment Year 2012-13 even though the amendment was carried with effective from Assessment Year 2015-16.

[1]Referred to in Schedule VII of the Companies Act, 2013
[2]National Small Industries Corp Ltd ITA NO.1367/Del/2016

The Honourable Tribunal has held that Explanation 2 to Section 37(1) cannot be construed as disadvantage to the assessee in the period prior to amendment. It went out on to held that such explanation is a disabling provision, as set out in Explanation 2 to Section 37(1), and refers to CSR expenses under Section 135 of Companies Act, 2013 and as such cannot have application for period not covered by this statutory provision which itself came into existence in 2013. The Tribunal has held that matter in favour of The National Small Industries Corp Limited by placing reliance on the decision of Honourable Supreme Court in the matter of CIT v Vatika Townships Private Limited ,[3] wherein it was held as under

Our belief in the nature of the law is founded on the bed rock that every human being is entitled to arrange his affairs by relying on the existing law and should not find that his plans have been retrospectively upset. This principle of law is known as lexprospicit non respicit: law looks forward not backward. As was observed in Phillips vs. Eyre: a retrospective legislation is contrary to the general principle that legislation by which the conduct of mankind is to be regulated when introduced for the first time to deal with future acts ought not to change the character of past transactions carried on upon the faith of the then existing law

We welcome the judgment of Honourable Delhi Tribunal for clearing the air that Explanation 2 to Section 37(1) is prospective in nature. There are numerous occasions where the judiciary has held that just because the explanation has been inserted to clear the doubts, such explanations would not have retrospective application. What has to be seen that whether such explanation has a substantial impact or not. If such explanation has a substantial impact on the way the matters held by tax payer, such explanation cannot be held to be having retrospective application despite of the fact that they have been introduced for removal of doubts.

Issue #2:

The next issue, we like to deal with is, whether CSR expenditure incurred voluntarily is also covered by Explanation 2 to Section 37(1) and hence attracts disallowance?

On a perusal of Explanation 2 of Section 37(1) inserted by Finance Act (No.2) 2014 provides that any expenditure incurred by the assessee on the activities relating to CSR referred to in Section 135 of the Companies Act, 2013 shall be disallowed.

Hence, in order to be ineligible under terms of Explanation 2 to Section 37(1), the pre-requisite is such CSR expenditure has to be incurred in terms of Section 135 of Companies Act, 2013.As per the said section, the obligation on CSR is applicable to the companies which meet the following criteria in the immediately preceding financial year[4]:

- Net worth of Rs. 500 Crores or more;
- Turnover of Rs 1000 Crores or more;
- Net Profit of Rs. 5 Crores or more

[3](2014) 367 ITR 466

[4]Companies (Amendment Act) 2017 w.e.f 19/09/2018

From above it is clear that CSR obligation is not applicable to all companies. Hence, the question is whether a company which is not obliged under Section 135 of Companies Act, 2013, if expends on CSR activities, will such expenditure get disallowed under Explanation 2 to Section 37(1) of Act. On a plain reading of Explanation 2 to Section 37(1), one can infer that such explanation is applicable to those companies which incurred CSR expenditure voluntarily also. However, we believe that this was not the intention.

Such question has come up for consideration by the Honourable Tribunal of Raipur in the matter of ACIT v Jindal Power Limited [5]. The Honourable Tribunal has stated vide Para 19 as under:

…….. This disallowance is restricted to the expenses incurred by the assessee under a statutory obligation under section 135 of Companies Act 2013, and there is thus now a line of demarcation between the expenses incurred by the assessee on discharging corporate social responsibility under such a statutory obligation and under a voluntary assumption of responsibility. As for the former, the disallowance under Explanation 2 to Section 37(1) comes into play, but, as for latter, there is no such disabling provision as long as the expenses, even in discharge of corporate social responsibility on voluntary basis, can be said to be "wholly and exclusively for the purposes of business". There is no dispute that the expenses in question are not incurred under the aforesaid statutory obligation. For this reason also, as also for the basic reason that the Explanation 2 to Section 37(1) comes into play with effect from 1st April 2015, we hold that the disabling provision of Explanation 2 to Section 37(1) does not apply on the facts of this case.

From the above, it is evident that Explanation 2 to Section 37(1) will not come into play in case of discharge of CSR on voluntary basis and be allowed as expenses as long as they incur wholly and exclusively for the purpose of business or profession.

[5] Jindal Power Ltd 70 Taxmann.com 389

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GST

INTEREST - COMPENSATORY OR COMPLEMENTARY

Contributed by CA Sri Harsha & CA Manindar

Introduction:

Traditionally, it was a well-accustomed practice under the Indirect Tax laws viz. Excise, Service Tax and VAT laws that interest is payable on the amount of tax due after adjustment of the input tax credit, that remains unpaid by the due date. Coming to GST laws, the said practice got dented under the concept of 'Electronic Credit Ledger', 'Electronic Cash Ledger' and 'Electronic Liability Ledger' and offsetting the liabilities with amounts in cash and credit ledgers through GSTR-3B returns. Recently, the Principal Commissioner, Hyderabad has issued a Standing Order No. 01/2019 dated 04.02.2019to clarify that interest is payable on gross liability including on the portion of the liability that was adjusted using the accumulated Input Tax Credit('ITC'). In this context, let us go through the statutory provisions and legal principles laid down by courts on this issue and accordingly understand the nuances of the clarification given in the said order.

Clarification given in standing order of Hyderabad Principal Commissionerate:

The Hyderabad Principal Commissioner vide their standing order (supra) has clarified that interest is payable for delayed payment of tax under section 50 of Central Goods & Services Tax Act, 2017 (CT Act) read with corresponding State Goods &Services TaxActs (ST Acts). Such interest is payable on gross liability (before adjustment of accumulated ITC) in cases where there is a delay in filing GSTR-3B return for offsetting the amount in 'Electronic Liability Ledger' with amounts in 'Electronic Credit Ledger' and 'Electronic Cash Ledger'.

The relevant extracts of the said order are reproduced hereunder:

6. Since ITC/Credit in balance in the 'Electronic Credit Ledger' cannot be treated as the Tax paid, unless it is debited in the said credit ledger while filing the return for off-setting the amount in the 'Liability Ledger', the interest liability under Sec. 50 is mandatorily attracted on the entire Tax remained unpaid beyond the due date prescribed. The ITC in balance as on the due date for filing the return has no relevance with regard to the interest liability u/Sec.50.It is immaterial whether the self-assessed tax is paid through the Credit/ITC or the Cash. Once the payment is beyond the prescribed date, interest liability is attracted on the entire Tax amount

Accordingly, instructions are given to the department officers to identify cases of belated filing of GSTR-3B returns and ensure whether interest is paid not only of the tax liability that was paid in cash but also on the tax liability that was paid using ITC. The impact of the clarification given on applicability of interest on tax dues is explained in the following example.

Example: XYZ Limited is required to pay an amount of Rs 30 lakhs towards taxes for the month of January 2019. The accumulated ITC balance as on 31.01.2019 is Rs 25 lakhs. The due date for filing GSTR-3B return and to pay the tax amount 20.02.2019. XYZ Limited has filed GSTR-3B return on 28.02.2019 by paying the balance Rs. 5 lakhs in cash. In this scenario, going by the above standing order, XYZ Limited is required to pay interest for delayed payment of tax for eight days on a gross liability of Rs. 30 lakhs but not on the net liability after ITC adjustment i.e. Rs. 5 lakhs.

Having understood the impact of the clarification in the Standing Order, when we compare with the erstwhile Central Excise, Service Tax, and VAT laws, the requirement to pay interest would arise only on the net liability to be payable in cash after adjustment of accumulated credit. In view of the contrary interpretation on this aspect between the current regime and the erstwhile regime, let us try to understand the reasons for the same.

Comparative Legal Provisions between Current regime and Erstwhile regime:

Section 50 of CT Act prescribes for payment of interest when there is a delay in payment of tax. The relevant extract is reproduced hereunder:

Section 50(1):

*Every person **who is liable to pay tax** in accordance with the provisions of this Act or the rules made thereunder, **but fails to pay the tax or any part thereof to the Government within the period prescribed, shall for the period for which the tax or any part thereof remains unpaid, pay, on his own, interest at such rate, not exceeding eighteen per cent.**, as may be notified by the Government on the recommendations of the Council*

Upon examination of sub-section (1) of Section 50, it only prescribes that interest is payable when there is a failure to pay the tax or any part thereof to the Government within the period prescribed. It does not expressly provide that tax is payable even on the extent of the tax liability that was offset with accumulated ITC. In the absence of such express intention under Section 50(1), whether such interpretation to pay interest even ontax liability that was met out of accumulated ITC holds good is required to be judicially tested. The reasons stated in the standing order for such conclusion is that the balance in 'Electronic Credit Ledger' cannot be treated as tax paid unless it is debited in the said ledger by offsetting the said amount with 'Electronic Credit Ledger' through the filing of GSTR-3B return.

The offsetting procedure followed in filing the returns is provided in Section 49 of the CT Act which provides for payment of GST, interest, penalty and other amounts. The said section provides for payment of tax liability using balances in electronic cash ledger and credit ledger. The relevant extracts are reproduced hereunder:

Sub-Section (3) and (4) of Section 49:

(3) The amount available in the electronic cash ledger may be used for making any payment towards tax, interest, penalty, fees or any other amount payable under the provisions of this Act or the rules made thereunder in such manner and subject to such conditions and within such time as may be prescribed.

(4) The amount available in the electronic credit ledger may be used for making any payment towards output tax under this Act or under the Integrated Goods and Services Tax Act in such manner and subject to such conditions and within such time as may be prescribed.

Sub-section (4) of section 49 provides that the amount available in electronic credit ledger may be used for making any payment towards output tax. In view of the existence of this provision, a view is possible that tax payment to the extent made by using ITC would be said to have been only by debit to electronic credit ledger which can be done only by way of filing of prescribed GSTR-3B return. In our view, though no reference was given to Section 49, this might be the reason for the Principal Commissioner to clarify that interest is payable even on the tax liability that was met out of accumulated ITC.

On the contrary to the said legal interpretation, let us examine the provisions of erstwhile Central Excise Act, 1944 and the rules made thereunder in connection with the payment of excise duty and interest for delayed payment of excise duty. Please note that the provisions of Service Tax and VAT laws also provide for similar interpretation to the one under Central Excise law. The said provisions are not reproduced to avoid repetition.

Section 11AA of Central Excise Act, 1944:

(1) Notwithstanding anything contained in any judgment, decree, order or direction of the Appellate Tribunal or any court or in any other provision of this Act or the rules made thereunder, ***the person, who is liable to pay duty, shall, in addition to the duty, be liable to pay interest at the rate specified in sub-section (2), whether such payment is made voluntarily or after determination of the amount of duty under section 11A.***

(2) Interest, at such rate not below ten percent and not exceeding thirty-six percent per annum, as the Central Government may, by notification in the Official Gazette, fix, shall be paid in terms of section 11A after the due date by the person liable to pay duty and such interest shall be calculated from the date on which such duty becomes due up to the date of actual payment of the amount due.

The said section provides for payment of interest on the amount of duty liable to be paid for a tax period. The provisions relating to tax payment are given in Rule 8 of Central Excise Rules, 2002. Sub-rule(1) of the said rule which is relevant in the present context is reproduced hereunder for ready reference:

(1) The duty on the goods removed from the factory or the warehouse during a month shall be paid by the 6th day of the following month, if the duty is paid electronically through internet banking and by the 5thday of the following month, in any other case

On perusal of sub-rule (1) of said rule, it provides that the assessee is liable to pay excise duty by sixth or fifth of the following month if the duty is paid through internet banking or in any other manner respectively. This implies that the payment within the due date has been provided for in the excise law only on the net liability to be paid in cash after adjustment of CENVAT Credit[1] .

Unlike the case of Section 49 of the CT Act, there was no provision being provided in Central Excise Law for adjustment of accumulated CENVAT credit with the corresponding output liability. The due date for payment of tax was only prescribed for the amount payable in cash and not for adjustment of accumulated CENVAT Credit. Accordingly, the requirement to pay interest under erstwhile Central Excise law is only on the net tax liability that was payable in cash after the due date.

With this understanding of the possible reasons for the different interpretation of said aspect in current regime as compared to the erstwhile regime, we now proceed to understand the principles laid down by judiciary on the collection of interest.

Principle laid down by Judiciary on collection of Interest:

Prathiba Processor's case:

The Supreme Court in the matter of Prathiba Processors v Union of India [2], has explained the distinction between the term 'tax', 'interest' and 'penalty' that are used in fiscal statutes. The relevant extract of the judgment is reproduced hereunder:

*13. In fiscal Statues, the import of the words - "tax", "interest", "penalty", etc. are well known. They are different concepts. Tax is the amount payable as a result of the charging provision. It is compulsory exaction of money by a public authority for public purposes, the payment of which is enforced by law. Penalty is ordinarily levied on an assessee for some contumacious conduct or for a deliberate violation of the provisions of the particular statute. Interest is compensatory in character and is imposed on an assessee who has withheld payment of an**y tax as and when it is due and payable. The levy of interest is geared to actual amount of tax withheld and the extent of the delay in paying the tax on the due date.** Essentially, it is compensatory and different from penalty - which is penal in character*

(emphasis supplied)

Bill Forge's case:

The Karnataka High Court in the matter of CCE v Bill Forge Private Limited [3], vide para 21, it was held as under:

[1]ITC under the earlier law was referred as CENVAT Credit.
[2]1996 (88) ELT 12 (SC)
[3]2012(26) STR204(Kar),2012(26) STR204(Kar)

Interest is compensatory in character, and is imposed on an assessee, who has withheld payment of any tax, as and when it is due and payable. The levy of interest is on the actual amount which is withheld and the extent of delay inpaying tax on the due date. *If there is no liability to pay tax, there is no liability to pay interest. Section 11AB of the Act is attracted only on delayed payment of duty i.e., where only duty of excise has not been levied or paid or has been short levied or short paid or erroneously refunded, the person liable to pay duty, shall in addition to the duty is liable to pay interest. Section do not stipulate interest is payable from the date of book entry, showing entitlement of CENVAT credit. Interest cannot be claimed from the date of wrong availment of CENVAT credit and that the interest would be payable from the date CENVAT credit is taken or utilized wrongly.*

(emphasis supplied
)

In view of the legal position laid down by Courts, a tax is a compulsory exaction of money if the levy gets attracted and a penalty is something penal in nature which is imposed for any attempt to evade tax or violate the provisions of the law. On the other hand, interest is compensatory in nature and it will be generally collected on the actual amount withheld by the taxpayer to the extent of delay in paying the tax on the due date. This would be so because the Revenue gets prejudiced to the extent of the delay. Whether the interpretation adopted in the standing order justify that the collection of interest for delayed tax payment is compensatory in nature? We will try to find the answer with the below scenarios:

Scenario#1:

During January 2019, XYZ Limited has purchased goods for Rs.10,00,000 from ABC Ltd. The invoice issued by ABC Ltd contains tax of Rs. 1,80,000/- making the total invoice value Rs. 11,80,000/-.ABC Ltd being the vendor is required to deposit the tax amount by 20.02.2019 by filing GSTR-3B return. XYZ Limited will avail the input tax credit of Rs. 1,80,000/- in the month of January 2019 only. The revenue involved in the said ITC reaches the exchequer by 20.02.2019.

The said goods are sold by XYZ Limited in February 2019 at Rs. 15,00,000/- with GST payable Rs. 2,70,000/-. The due date for deposit of the amount by filing GSTR-3B is 20.03.2019. Suppose, XYZ Limited has delayed the return by 10 days and has filed by 30.03.2019. In such a situation, going by interpretation of standing order, XYZ Limited is required to pay interest on the entire due amount of Rs. 2,70,000/- including the amount of Rs. 1,80,000/- towards ITC which in fact has reached the exchequer by the due date. To this extent, there is no loss to the exchequer. But the standing order mandates the collection of interest on Rs. 2,70,000/- instead on Rs. 90,000/-. Such practice amounts to an undue collection of interest even though there was no loss to the exchequer.

Scenario #2:

Assuming the facts of the above example remain the same except that ABC Limited has failed to file the return and pay the tax by 20.02.2019. Instead, the said return was filed on 10.03.2019. In such event, interest is collected on the due amount of Rs. 1,80,000/-from both ABC Limited as tax due in cash and from XYZ Limited as ITC not being set-off in time by filing GSTR-3B return. In this situation, there is a loss to the exchequer to the extent of Rs. 1,80,000/- from ABC Limited and Rs. 90,000 from XYZ Limited. But interest is recovered on Rs. 1,80,000 from ABC Limited and on Rs. 2,70,000 from XYZ Limited. This implies that interest ispayable on revenue loss to the extent of Rs. 1,80,000/- is recovered from two taxpayers.

Suppose the customer of XYZ Limited availed input tax credit of Rs. 2,70,000/- and there was a delay in offsetting the tax payable by him in subsequent months. In such an event, it can be concluded that interest on revenue loss to the extent of Rs. 1,80,000/- will be recovered from three taxpayers and interest on revenue loss to the extent of Rs. 90,000/- will be recovered from two taxpayers. This implies that the recovery of interest on the same amount of tax on more than one occasion goes on as many times as the suppliers in the supply chain defaults in filing GSTR-3B return within due date to offset the gross liability towards tax.

In view of the above scenarios, the interpretation that interest is payable on the gross liability including the amount of liability that was paid using accumulated ITC would result into collection of interest even when there was no loss of revenue or collection of interest from more than one tax payer involved in the supply chain in the event where there is a simultaneous default in filing the GSTR-3B returns. Therefore, this interpretation does not support the view that the amount of interest collected is compensatory in nature. In fact, it can be said that such collection is complementary to the revenue collected by Governments because interest is collected on the same amount of revenue on more than one occasion from different taxpayers. Therefore, as the interpretation of standing order is going against the principle that interest is compensatory in nature, the same is required to be tested judicially.

Further, it is worth to observe that Rule 87 of Central Goods & Services Tax Rules, 2017 (CT Rules), vide sub-rule (6) and (7) state as under:

(6) On successful credit of the amount to the concerned government account maintained in the authorised bank, a Challan Identification Number shall be generated by the collecting bank and the same shall be indicated in the challan.

(7) On receipt of the Challan Identification Number from the collecting bank, the said amount shall be credited to the electronic cash ledger of the person on whose behalf the deposit has been made and the common portal shall make available a receipt to this effect.

From the above, it is evident that the moment payment of taxes is made, the Challan Identification Number (CIN) will be generated, and the corresponding tax amount reaches the government account maintained by collecting bank. In other words, the assessee while making payment of tax, the CIN gets generated only once the tax amount has reached the concerned government account. What only remains from the assessee/tax payer is an offset procedure which is pure technical in nature. The amounts which are in Electronic Cash Ledger and Electronic Credit Ledger must be used for offsetting the liability in Electronic Liability Ledger and the same is done by filing the GSTR-3B return.

In such a situation, once the credit and cash are in respective ledgers (which by that time belongs to the respective governments), the delay in action of assessee / tax payer off setting them with liability because of delayed filing of return attracting interest is illogical, since there is no loss to the revenue. In such event, interpreting the delay in remittance of tax under Section 50 by giving due emphasis to the offset procedure laid down under sub-sections (3) and (4) of Section 49 may not be rational.

Understanding the ambiguity involved in interpretation of Section 50 towards collection of interest, the GST Council in their 31st Meeting has recommended amendment to the said section that interest should be charged only on the net tax liability of the taxpayer after considering the admissible input tax credit i.e. interest payable on the amount paid through Electronic Cash Ledger.
Despite such recommendation, the Hyderabad Principal Commissioner has issued the subject standing order clarifying that interest is payable on gross liability. Based on such recommendation, notices are issued by Department officers to recover interest on gross liability from taxpayers who have filed their GSTR-3B returns belatedly. In view of this reason, an appropriate recommendation is required to be made to withdraw the said order and to ensure that the amendment proposed to Section 50 should be given retrospective effect.

Conclusion:

Summing up the above discussion, the standing order mandates the recovery of interest under Section 50 on the gross liability towards GST including the amount of ITC adjusted towards such liability. However, the language of Section 50 does not expressly provide for such intention to collect interest on gross liability. The reason could be because of set-off requirement while filing GSTR-3B return under Section 49 as discussed above. Such interpretation leads to the collection of interest even though there was no revenue loss or collection of interest from more than one person on the same amount of revenue loss, thereby, distorts the well-established legal principle that interest is compensatory in nature and rather it turns out to be complementary to revenue. Hence an appropriate representation is required to be made to withdraw the said standing order and to ensure retrospective effect to the amendment recommended to Section 50 by GST Council.

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AUDIT

QUALITY AUDIT REPORTS

Contributed by CA Sandeep Das

The purpose of the audit report is to summarize the findings in a way that auditee management can readily understand and see the impact of these findings. The audit report represents the end result of weeks of reviews, analyses, interviews and discussions. It provides important information to audit clients about the area reviewed by internal audit.

More importantly, it provides details to management about significant issues that need to be addressed. How well internal auditors communicate that information is critical to getting their client's acceptance of findings and their agreement with audit recommendations.

Quality reports require thought and effort. Auditors should consider who will read the report, what they will do with it, what level of detail is necessary, what the organization's culture and norms call for, and if industry-specific language is necessary. Every effort should be made to ensure the report is kept at a reasonable length and conveys a balanced summary of the status of the areas audited.

Quality of Communication says communications should be accurate, objective, clear, concise, constructive, complete, and timely – IIA Standard 2420.

The audit report needs to be issued as soon as possible after the audit is completed. If, for any reason, it cannot be issued by the deadline set in the audit plan, an explanation for the delay should be provided to the auditee and a revised issue date established.

Significance of Accuracy

Inaccurate information could adversely impact the credibility of the entire audit report, so accuracy is critical. All of the numbers should be correct, the information should be factual, and documentation verifiable. There may be disagreement on what the numbers or facts mean, but there should never be an argument about their accuracy. Accuracy is enhanced by appropriate supervision of the audit engagement.

The IIA's International Standards for the Professional Practice of Internal Auditing requires adequate supervision of engagements, and part of that includes verification of numbers and facts. Accurate and precise information lessens the chance of a misunderstanding.

The audit report is shared among the audit team, and with the audit organization's management, for review of accuracy and completeness. The integrity of the audit report process is the lead auditor's responsibility and he/she must ensure that it reflects the tone and content of the audit. The audit report is signed and dated, minimally by the lead auditor, before distribution.

Objectivity

Objectivity is the second most important quality behind accuracy. If readers feel that the report is not objective, it could undermine the confidence they have in the report. And while the report may be objective, the subtle use and placement of certain words can appear to show bias. This can be crucial to whether the reader accepts the auditor's conclusions and recommendations.

Objective words are precise. They speak to the facts and can be supported by evidence. The report should always mention positive actions and practices that were observed during the audit. Certainly nonconformances and non-compliances that were identified during the completion of the audit must be documented, as well as any opportunities for improvement.

Reports must be clear enough for readers to understand without having to refer to anything else. Language should include precise modifiers and clear technical terms.

Attributes of an effective audit report

Precise Modifiers- A modifier is a word or phrase that alters the meaning of another word. Generally, the modifying word should be as close as possible to the word it is modifying. Otherwise, the modifying word could attach itself to a word that was not intended to be modified. This can subtly alter the meaning of the sentence or make it ambiguous.

Usage of clear Technical Terms - Auditors should consider spelling out acronyms, replacing technical terms with nontechnical words, and embedding definitions within the sentence.

Documentation of nonconformities: When documenting findings, it is important to be clear and precise. What is the actual nonconformity and why is it a nonconformity? What standard has been violated? What is the objective evidence used to determine that a nonconformity exists? The statement of nonconformity needs to be well written, clear and precise with enough detail that the auditee or process owner can use it to initiate root cause analysis

Conciseness - Readers always appreciate conciseness, but it should not mean cutting down on information. It means using fewer words to convey the same information. For example, if there are findings in three different areas regarding document control, combine them into one finding that indicates where the non-conformities were noted. Some things that impact conciseness include drawn-out verbs, overstated language, and redundant modifiers.

Constructiveness - Constructiveness primarily refers to the audit recommendations, which should give audit clients information to correct the current problem and also address the root cause so as to mitigate future occurrences.

Completeness - Everything the reader needs to make an informed decision should be included in the report, and no significant information should be left out. The auditor must not omit valid information because it does not support his or her points. Present all the facts and allow the reader to decide. "Communications must include the engagement's objective, scope, and results" – Standard 2410. Audit report is not complete without the reason for the audit, the final conclusion based on the evidence reviewed, and the amount of evidence reviewed to come up with the conclusion.

Areas of Improvement - It is permissible for auditors to make statements, or judgments, regarding the auditee's compliance with the applicable system standards and related documentation.

Timeliness - Auditors should complete and issue reports as soon as possible to give the audit client a chance to address the issues timely. Timeliness may vary based on things like the audit resources needed to complete the audit, the complexity and significance of the audit, the report review process, and other factors. If serious issues need to be communicated before the report is completed the auditor should immediately issue an interim report or memo to allow the client the opportunity to address the problems as soon as possible. The interim report or memo can be referenced in the final report.

Distribution list - For internal audits, the audit report distribution tends to be much larger, but is typically specified in an internal procedure governed by the audit group management.

Conclusion:

An audit report must be accurate and objective; flexible enough to communicate sometimes complex information to various levels of people; and able to withstand the scrutiny of peer reviews and other assessments, depending on the industry. A quality audit report aids audit client in making informed decisions, so taking the time and effort to put it together benefits the audit client and auditor

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FEMA

ROUND TRIPPING-FEMA PERSPECTIVE

Contributed by CA Murali Krishna G & CA Bharani

Introduction:

The word "Round Tripping" in common parlance means an act of starting from one place / country and coming back to the same place / country. It denotes a trip where a person or thing returns to the place from where the journey began. However, this word is widely used in economics / finance where funds go out of a country and come back in to the country. Such round-trips can be seen in investments and trade as well. In the context of black money, it leaves the country through various channels such as inflated invoices, payments to shell companies overseas, the hawala route and so on. After cooling its heels overseas for a while, this money returns to the country in a freshly laundered form; thus, completing a round-trip. In short, round tripping creates a nexus between the funds gone out of India and funds came into India.

Though the funds involved in round tripping need not necessarily be illegal or illicit, the word has been used extensively referring transactions involving such funds. Intention behind such transactions does have importance. Much like Marxism, round trips were elegant in theory but corrupted by the fraudulent ambitions and shortcomings of flawed individuals. While the theory behind round trips was sound and perfect in keeping with the spirit of the times, the practice ultimately proved damaging because of intentions behind them.

Motto behind round tripping may be to avail tax treaty benefits and incentives, leverage interest rates, launder illegal money thereby changing its colour as legal, evade taxes, inflating books of accounts etc. Round tripping is indeed a widely used money laundering method. Considering the negative impact, money laundering has on economy, it has become obvious for various financial regulators to continuously monitor anti-money laundering initiatives and improve the same on a regular basis.

Foreign Exchange Management Act, 1999('FEMA') and the Prevention of Money Laundering Act, 2002('PMLA'), inter alia, are the two major legislative systems in India that aim at controlling illegal money. Besides SEBI also issues guidelines in the matters where money-laundering is expected through dealings in securities.

Treaty Shopping Vs Round Tripping:

With capital becoming globalised, international investors look for the minutest of opportunities across the world to improve return on their investments. One of the attractive parameters for such investors is tax treaty advantage. Investors look for benefits from tax treaties with various countries and accordingly invest their funds in such countries. Such investments, many a time, fall into a grey zone where the difference between legal and illegal becomes very thin. Two such grey zone cases refer to 'treaty shopping' and 'round tripping'.

For example, an investor from country A wants to invest in country B but finds out a beneficial treaty between country B and country C, wherein the investments by country C in to country B attract lower tax. Instead of investing directly from country A to B, the investor tries to invest indirectly through country C, thereby legally availing the tax treaty benefits. This is called "Treaty Shopping".

There arises an extreme case of treaty shopping when it is used by domestic investors. From above example, if a domestic investor of country B first makes investment in country C by establishing a shell company there to acquire the legal identity as a resident of country C, and then such shell company invests in country B disguised as foreign investment, it becomes a case of "Round Tripping". By doing so, the investor illegally avails the benefits and advantages offered to foreign investments in its country.

Rounding tripping, in Indian context, may be direct wherein funds have gone out of India to one foreign entity, and the same foreign entity invested in another Indian entity. Alternatively, to avoid easy traceability of funds remitted, multiple layers of companies may be floated outside India in multiple countries, and finally bring back the funds to India as investment. By engaging in practices such as treaty shopping and round tripping, many investors and firms can escape paying their fair share of taxes, which results in loss of valuable tax revenue for governments.

Round Tripping through Hawala mechanism:

"Hawala" is a method of transferring money without any money actually moving. Hawala is an alternative remittance channel that exists outside of traditional banking systems (also known as underground banking). Transactions between hawala brokers are made without promissory notes because the system is heavily based on trust and balancing of the hawala brokers' books. Since, hawala transfers are not routed through banks and, hence, not regulated by governmental and financial bodies, it becomes highly difficult to trace the legitimacy of money involved in such transactions. Illegal money generated in India may move out of India through hawala brokers (without physical movement of money) and same illegal money, with actual source unknown, comes back to India legally through banking channels either in the form of trade remittances or equity investments or any other mode. Hawala is strictly prohibited under anti-money laundering laws of many countries.

Round Tripping - FEMA guidelines:

As discussed earlier, one of the mostly used form of round tripping which attracts FEMA provisions is investments, where funds go out of India as Overseas Direct Investment ("ODI") and comes back to India in the form of Foreign Direct Investment ("FDI"). Such investments are usually made to avail tax benefits which are available to foreign investors. When round tripping is resorted to with mala fide intention of money laundering, it goes beyond the scope of FEMA, and it attracts provisions of PMLA. Accordingly, the jurisdiction gets transferred from Reserve Bank of India ("RBI") to Enforcement Directorate ("ED").

Round tripping is not defined under FEMA, and neither there are direct regulations which talk about round tripping. The only provision which indirectly deals with round tripping is Regulation 6(2)(ii) of Foreign Exchange Management (Transfer or Issue of any Foreign Security) Regulations, 2004 ("ODI Regulations") as amended from time to time. Regulation 6 of ODI Regulations deals with guidelines on overseas investment by Indian entity. The text of regulation 6(2)(ii) is as follows:

"The direct investment is made in an overseas JV or WOS engaged in a bona fide business activity."

As can be seen, the scope of regulation 6(2)(ii) is wide enough. The word bona fide includes not only round tripping but also any other activity which is not aligned with FEMA provisions. This rationale is based on various pronouncements by RBI in the form of Compounding Orders.

For the limited purpose of understanding the provisions elucidated in Compounding Orders, round tripping (ODI-FDI structure) can be classified as Direct Round Tripping and Indirect Round Tripping. For example, if X Ltd, an Indian entity, invests in Y Ltd, an overseas entity (through ODI), and Y Ltd in turn invests in Z Ltd, an Indian entity (through FDI), such transactions can be terms as Direct Round Tripping. This creates a direct nexus between ODI funds and FDI funds. Same will be the case even if the funds come in to India after moving through multiple layers of investment companies overseas.

And from above example, if by the time X Ltd invests in Y Ltd (ODI), Y Ltd already holds stake in Z Ltd (FDI), the transactions of X Ltd investment in Y Ltd can be termed as Indirect Round Tripping, which creates an indirect nexus between ODI funds and FDI funds.

Though direct round tripping can be termed as prohibited under FEMA, indirect round tripping is per se not prohibited. There can be genuine business acquisitions which may lead to indirect round tripping because of existing organization structure of acquired company. In such cases, the acquirer should take prior approval from RBI before concluding such acquisition. Of course, transactions involving illegal / illicit money are anyway prohibited.

Sometimes it may happen that an overseas subsidiary or joint venture has accumulated profits over a period of time and has surplus cash reserves, which are then invested in an Indian entity. In such case, it may be argued by investors that there is no direct nexus between ODI funds and FDI funds, as the investment is made from accumulated reserves. However, such scenario will still fall under indirect round tripping, and is prohibited.

In case, where an investment transaction is made, out of ignorance, resulting in ODI-FDI nexus and thereby leading to contravention, such transaction can be ratified by taking either ex-ante or ex-post approval from RBI. A suitable application to RBI placing all the relevant facts therein may be made in this regard. Based on facts of the case, RBI may grant its approval and may subject the same to unwinding the ODI-FDI structure and compounding thereafter, based on the direction of RBI. If the case involves money laundering, RBI may refer the same for prior approval of ED or for adjudication proceedings by the ED.

Below are few Compounding Order pronouncements by RBI where it confirmed that round tripping is not a bona fide activity.

1. Halcyon Finance and Capital Advisors Private Limited (HFC)

   HFC set up a wholly-owned subsidiary ('WOS') namely, Infra health Pte Ltd, Singapore and remitted funds during 2010 and 2012 towards acquisition of its equity shares. Thereafter, the said overseas WOS acquired the entire stake in an Indian entity from another non-resident entity. Also, it made further investments in to the Indian entity. Thus, Indian entity became a subsidiary of the overseas WOS and a step-down subsidiary of HFC.

Since foreign direct investment (FDI) through overseas direct investment (ODI) is not a bona fide business activity in terms of the provisions of Regulation 6(2)(ii) of ODI Regulations. The above is an example of investment through indirect round tripping.

2. Binani Industries Ltd (BIL)

BIL incorporated a Special Purpose Vehicle (SPV) in Luxembourg under name style 3B Binani Glass fibre S.a.r.l.(3B Binani). Further, BIL also held 100% shares in Goa Glass Fibre Limited (GGFL), India.

As part of its merger and acquisition strategy, BIL merged the operations of GGFL with 3B Binani, Luxembourg. BIL initially sold 49% of its stake in GGFL to 3B Binani in February 2012 under Automatic Route and balance stake of 51% in GGFL to 3B Binani in October 2012.By doing so, GGFL became subsidiary of 3B Binani which is held by BIL.T his created an indirect nexus between ODI and FDI, which is not in line with the provisions of Regulation 6(2)(ii) of ODI Regulations. However, considering that the acquisition of GGFL by 3B Binani was done for the purpose of achieving business synergy and business consolidation, RBI provided its post facto approval in this case.

3. RIR Enterprises (RIR)

RIR is a registered partnership firm with three members as partners. It incorporated a Wholly Owned Subsidiary (WOS) under name style RRI International Limited, Mauritius.

The partnership firm issued corporate and personal guarantees to the extent of USD 300 million and USD 38.7 million respectively on behalf of its WOS to ICICI Bank, Bahrain, to enable the WOS to raise a loan of USD 30 million. Such guarantees are also considered as financial commitment under ODI Regulation. WOS invested the loan proceeds in Compulsorily Convertible Preference Shares ('CCPS') of an Indian company, Sieger Solutions Ltd (SSL) in which two of three partners were already directors along with others. Further, WOS pledged the CCPS as a further collateral with ICICI Bank, Bahrain.

The firm failed to provide any documentation to prove that the said WOS was engaged in any activity other than funnelling the loan proceeds back into the country. The loan was raised overseas at a lesser rate. Also, the business activity of SSL doesn't permit it to raise ECBs. Hence, it was clear that the overseas investment transaction was routed only for the purpose of leveraging interest rates and bring funds in to India against law. RBI pronounced that the above modus operandi is not bona fide within Regulation 6(2)(ii) of ODI Regulations and is prohibited.

4. VFS Global Services Pvt Ltd (VFS Global)

VFS Global was previously known as Kuoni Visa Services Private Limited (Kuoni India). Kuoni India was a JV between Kuoni Asian Investment Mauritius Limited (Kuoni Mauritius) and Kuoni Travel Holding Limited, Switzerland (FDI).

VFS India Pvt Ltd. (VFS India) incorporated a WOS namely VF Worldwide Holdings Ltd., in Mauritius (VFS Mauritius) (ODI).

Later, VFS India amalgamated with Kuoni India, pursuant to a court approved Scheme of Amalgamation. Post-amalgamation, the legal existence of VFS India ceased to exist. Pursuant to the Scheme of Amalgamation, all assets and liabilities of VFS India were transferred to Kuoni India which includes the stake held in VFS Mauritius. This created a nexus between FDI and ODI.

Thereafter, Kuoni Mauritius sold its stake in Kuoni India to VFS Mauritius, thereby leading to cross holding of investments(Kuoni India post amalgamation having stake in VFS Mauritius and in turn VFS Mauritius having stake Kuoni India).

This is another case of indirect round tripping, which is not a bona fide activity under ODI Regulations.

5. Lisaline Lifescience Technolgoies Pvt Ltd (LLT India)

LLT India set-up a Joint Venture (JV) namely, Lisaline Life science Technologies LLC (LLT LLC) in UAE during 2006.LLT LLC generated surplus overa period, later in 2012 remitted funds to LLT India as FDI for expansion of the business activities. This is an example of direct round tripping which was not a bona fide activity under Regulation 6(2)(ii) of ODI Regulations.

Apart from ODI-FDI structures for round tripping, investors are misusing GDR (Global Depository Receipts) mechanism by creating series of entities in offshore locations for multi- layered transfers of funds, and finally investing in Indian GDRs. SEBI vide its circular dated September 21, 2018 allowed non-resident Indians, overseas citizens of India and resident Indians to be constituents of foreign portfolio investors and permitted resident Indians to make remittances under Liberalised Remittance Scheme (often referred as LRS) towards contribution to global funds. Accordingly, resident Indians can invest in global funds which may deploy substantial amount of its funds in India, and this may be termed as round tripping by tax officials. RBI is yet to provide guidance in this matter.

Round tripping may also attract GAAR (General Anti Avoidance Rules) provisions under Income Tax Act, which are mainly aimed at funds, companies and individuals escaping tax. GAAR mainly applies to situations where an investment route or tax haven is merely used for tax arbitrage/ treaty shopping or to escape domestic taxes.

Round Tripping in Trade:

As discussed earlier, round tripping is not just limited to investments, but also can be seen in trade. Over-invoicing or under-invoicing, fake export invoices with no actual shipments or under-shipments, multiple invoicing for same goods, etc., are widely used methods used in trade for transferring illegal money. The recent Nirav Modi case is a classic example for round tripping in trade, where a particular type of rare diamond was imported and exported multiple times through various sham companies (around 47 times as per ED estimate), each time with exorbitant increase in value. Of course, in this case, banks took a hit due to fake LOUs.

In 2013, the then Government of India introduced 80:20 scheme for gold imports, in order to control fiscal deficit. As per said scheme, up to 80% of gold imported could be sold in the country on condition that 20% was exported. The next import was allowed only after export of said 20%.Initially only banks and state-owned agencies such as MMTC and STC were allowed to import gold for domestic use under the scheme. However, in May 2014, RBI allowed certain premier export houses to import gold subject to some restrictions. RBI had relaxed the rules at the behest of the Ministry of Finance after jewellers, Authorised Dealer Banks and trade bodies lobbied for relief. This was done to facilitate gem and jewellery exports, which had decreased due to the curbs.

The said scheme was fraudulently used by many gold and jewellery dealers. Importers used to import gold bars and export 20% thereof as jewellery to countries where customs duly on import of jewellery is comparatively less than other countries. Such exported jewellery used to be converted in to gold bars, and again imported in to India, thereby leading to round tripping. By doing so, dealers got unduly benefitted from export incentives and other trade benefits. It is alleged that Nirav Modi's companies were also benefitted under this scheme.

Conclusion:

Though many controls are put in place by RBI (like mandatory KYC for investments, IDPMS and EDPMS in trade), still round tripping transactions escape the eyes of regulators due to its complexity, multiple layered structures, and especially cross-border nature. It is expected that Global initiatives like BEPS and rapidly increasing exchange of information between countries may reduce round tripping transactions in near future. Also, the recent changes in the Companies Act, 2013 with respect to the disclosure of Significant Beneficial Owners of Indian Companies, may to some extent address the round tripping related issues.

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