

**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 May 2023:

**Income tax rulings**

- **Alternate accommodation & hardship receipts from builder in case of redevelopment projects are capital in nature**

- Ajay Parasmal Kothari<sup>1</sup>

The taxpayer had filed his Return of income for FY 2012-13 on 27 March 2013 declaring an income of INR 1,690,830. The return was selected for scrutiny. The tax officer observed a monthly credit in the capital account of INR 373,191 from a builder for taxpayer's flat which was under redevelopment. The tax officer reclassified the income as Income From Other Sources. The taxpayer contended that the receipt was capital in nature as it was towards hardship compensation and thus not taxable. The tax officer observed that receipt was for alternate accommodation. However, the taxpayer had not utilised the amount for any alternate accommodation. The tax officer therefore considered the income to be taxable as Income From Other Sources. The First Appellate Authority upheld the order passed by the tax officer.

The Tribunal observed while the taxpayer had received a monthly amount of INR 373,191 from the builder for alternate accommodation, the taxpayer had not utilised it for renting a new accommodation as he lived with his parents. The Tribunal observed that the taxpayer did face hardship of vacating the flat for redevelopment. Relying on the Mumbai Tribunal decision on a similar issue in the case of *Smt Delilah Raj Mansukhan*<sup>2</sup>, the Tribunal held that the receipt is capital in nature and towards hardships faced by the taxpayer due to redevelopment and not in the nature of revenue receipt.

**JMP Insights** – *Taxability of compensation received from the builder in redevelopment cases is a contentious issue.*

*Under the Income-tax Act, 1961 ('the Act'), capital receipts are taxable only in case they are specifically included in the definition of 'income'. Hardship allowance being a capital receipt is not considered as taxable income.*

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<sup>1</sup> ITA No.2823/MUM/2022

<sup>2</sup> ITA. NO 3526/Mum/2017

*The nature of income cannot be necessarily inferred from the frequency of receipt. As seen in this case, hardship compensation was received monthly; however, it cannot be considered to be a revenue receipt only because of its recurring nature.*

### **Income Tax Notifications**

#### **Relaxation from the rigors of Angel tax**

As per section 56(2)(viib) of the Act, if an unlisted Indian company issues shares at a value which exceeds its Fair Market Value ('FMV') then such unlisted Indian company is required to pay tax on the difference between the consideration received for issue of such shares and the FMV of such shares.

Till 31 March 2023, the section was applicable only in the case of issue of shares to a resident shareholder. The Finance Act, 2023 expanded the scope of the section to include issue of shares by unlisted Indian companies to a non-resident as well.

Section 56(2)(viib) of the Act is not applicable in the following cases even if the issue price of shares exceeds the FMV:-

- Issue of shares by a venture capital undertaking to a venture capital company or a venture capital fund or a Category I or Category II alternative investment fund ('AIF') registered with the Securities and Exchange Board of India ('SEBI') or AIF set up in the International Financial Services Centres ('IFSC'); and
- Issue of shares by a company to prescribed classes of persons *as may be notified*.

The Central Board of Direct Taxes ('CBDT') has released notifications specifying certain relaxation which is discussed as under:

- (i) **Relaxation for start-ups** - Extension of exemption for start-ups in connection with investment received from specified non-residents.
  - (ii) **Exclusion for certain persons** - Class of persons/entities from which investments would not attract angel tax provisions.
- **Relaxation for start-ups<sup>3</sup>**
    - An eligible start-up company (which fulfills the conditions as laid down in the notification<sup>4</sup> issued by the Department for Promotion of Industry and Internal Trade), can issue shares to any person at a price that is more than its FMV.
    - The aforesaid provision is made retrospectively applicable from 1 April 2023.

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<sup>3</sup> Notification No. 30/2023 F. No. 370142/9/2023-TPL (Part-I) dated 26 May 2023 (Relaxation for Start-ups)

<sup>4</sup> Notification No. G.S.R. 127(E) dated 19 February 2019

- **Relaxation extended to companies for the issue of shares to notified persons<sup>5</sup>**

CBDT via the Exclusion Notification has provided that the provisions of Section 56(2)(viib) of the Act will not be applicable in cases where consideration for the issuance of shares is received from the following classes of persons:

- Government and Government related investors such as Central Banks, Sovereign Wealth Funds, International or Multilateral Organisations or agencies including entities controlled by the Government or where direct or indirect ownership of the Government is 75% or more;
- Banks or entities involved in insurance business where such entity is subject to applicable regulations in the country where it is established/incorporated/resident;
- Following entities, provided they are residents of 21 countries (namely, Australia, Austria, Belgium, Canada, Czech Republic, Denmark, Finland, France, Germany, Iceland, Israel, Italy, Japan, Korea, New Zealand, Norway, Russia, Spain, Sweden, United Kingdom and United States of America):-
  - Entities registered with SEBI as Category-I Foreign Portfolio Investors ('FPIs');
  - Endowment funds associated with a university, hospitals or charities;
  - Pension funds created or established under the law of the foreign country/specified territory; and
  - A pooled investment vehicle or fund where the number of investors in such vehicle or fund is more than 50 and such fund is not a hedge fund or a fund that employs diverse or complex trading strategies.

**JMP Insights** – *The aforesaid notification gives only partial relaxation i.e. issue of shares to any person not covered above will trigger the provisions of section 56(2)(viib) of the Act.*

*Jurisdictions like Singapore, Mauritius, Netherlands, Luxembourg and Cyprus are often used for investing in India due to their favourable regulatory regime. These jurisdictions are not included in the Financial Action Task Force ('FATF') grey list or black list. Entities investing through these jurisdictions have not been excluded. There is no exemption for shares issued to holding companies or for internal restructuring. Further, no exclusion has been carved-out to accommodate valuation of shares to non-resident shareholders in a rights issue by an unlisted company.*

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<sup>5</sup> Notification No. 29/2023 F. No. 370142/9/2023-TPL (Part-I) dated dated 24 May 2023 (Exemption Notification)

➤ **Draft Rule 11UA for computing the FMV of equity shares<sup>6</sup>**

Rule 11UA(2) of the Income-tax Rules, 1962 allows a taxpayer to value unquoted equity shares of a company at the time of issue of such shares either by Net Asset Value ('NAV') Method or by the Discounted Cash Flow ('DCF') method. If the shares are issued by the unlisted Indian Company at FMV determined on DCF or NAV basis, then no tax incidence arises on account of section 56(2)(viib) of the Act.

The CBDT has now issued draft rules have been released to seek suggestions/comments from stakeholders:

In the draft rules, the following are the options provided to the taxpayer amongst which one can adopt any option to value the equity shares to be issued as per section 56(2)(viib) of the Act:-

1. **Option A:** Adjusted NAV method
2. **Option B:** DCF method for which the valuation report needs to be obtained from a merchant banker
3. **Option C:** A Venture Capital Undertaking can issue equity shares to any person at the same price at which it had issued equity shares to a Venture Capital Company ('VCC') or Venture Capital Fund ('VCF') or a Specified Fund provided –
  - a. the aggregate consideration receivable for issue of shares to such person should not exceed the aggregate consideration received from such VCC or VCF or Specified Fund; and
  - b. equity shares should be issued within a period of 90 days from issue of shares to VCC or VCF or Specified Fund.
4. **Option D:** Five new valuation methods have been prescribed and such a valuation can be carried out by a merchant banker only. These 5 new methods are as follows:-
  - i. Comparable Company Multiple Method;
  - ii. Probability Weighted Expected Return Method;
  - iii. Option Pricing Method;
  - iv. Milestone Analysis Method; and
  - v. Replacement Cost Method.

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<sup>6</sup> Notification F. No. 370142/9/2023-TPL (Part-I) dated dated 26 May 2023 (Draft Valuation Rules)

5. **Option E:** A company can issue equity shares to any person at the same price at which it had issued equity shares to a notified entity provided -
  - a. the aggregate consideration receivable from such person should not exceed the aggregate consideration received from such notified entity; and
  - b. shares are to be issued within a period of 90 days from the date of issue of equity shares to notified entity.

Issue of shares to resident can be valued using NAV, DCF or actual transaction price method listed at point no. 1, 2, 3, or 5 above. For valuation of shares issued to non-resident entities, additional 5 methods listed at Point 4 are now available.

A 10% deviation from the issue price is proposed to be accepted as a safe harbour (i.e. without any tax consequence).

**JMP Insights** – The aforesaid draft rules are subject to changes based on comments from various stakeholders. Further, these valuation rules are only applicable for the issue of equity shares by unlisted Indian companies and hence, these draft valuation rules are not applicable for the issue of preference shares/transfer of equity or preference shares.

### **Notifications under the Prevention of Money-Laundering Act, 2002**

The Ministry of Finance ('MoF') has recently extended the applicability of certain compliance obligations under the Prevention of Money-Laundering Act, 2002 ('PMLA') to Chartered Accountant ('CA'), Company Secretary ('CS') or Cost Accountant ('CWA') holding a certificate of practice ('COP') practicing individually or through a firm/limited liability partnership ('LLP').

The PMLA imposes due diligence obligations on Specified Reporting entities. It also provides that any class of persons defined as a 'person carrying on designated business of profession is a Reporting Entity for this purpose and Central Government is empowered to designate any person as such. Accordingly, MoF vide notifications dated 3 May 2023 (Notification I) and 9 May 2023 (Notification II) has expanded the scope of the Reporting entities as follows:

- **Relevant persons carrying financial transactions in relation to specified activities to be covered as reporting entity<sup>7</sup>**
  - Any relevant person carrying financial transactions on behalf of a client in relation to the following activities will be covered as a reporting entity:
    - Buying and selling of any immovable property;
    - Managing of client money, securities or other assets;
    - Management of bank, savings or securities accounts;
    - Organisation of contributions for the creation, operation or management of companies; and

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<sup>7</sup> Notification I - Notification No. F. No. P-12011/12/2022-ES Cell-DOR dated 3 May 2023

- Creation, operation or management of companies, LLPs or trusts and buying and selling of business entities.
- Relevant person includes an individual who is a CA, CS or CWA holding a COP practicing individually or through a firm/LLP.
- **Persons carrying specified activities to be regarded as reporting entity<sup>8</sup>**
  - A person will be covered as a reporting entity for carrying out the following activities:-
    - Acting as a formation agent of companies and LLPs;
    - Acting/Arranging for another person to act as –
      - a director or secretary of a company, partner of a firm or a similar position in relation to other companies and LLPs;
      - a trustee of an express trust or performing the equivalent function for another type of trust;
      - a nominee shareholder for another person; and
    - Providing a registered office, business address or accommodation, correspondence or administrative address for a company or a LLP or a trust.
    - However, the following activities if carried out by a person are excluded resulting into the non-applicability of the reporting obligations cast upon:-
      - Any activity to give on lease or any arrangement for use of land or building or any space for a consideration which is subject to withholding of tax under section 194-I of the Act;
      - Any activity that is carried out by an employee on behalf of his employer in the course of his employment;
      - Any activity that is carried out to the extent of filing a declaration in connection with the formation of a company as required under section 7(1)(b) of the Companies Act, 2013 ('Companies Act'); and
      - Any activity that is carried out in the capacity as an intermediary defined under section 2(1)(n) of the PMLA.

***JMP Insights:***

*As per Notification I, a relevant person engaging in any financial transaction in relation to the specified activities is classified as a reporting entity. A CA, CS or CWA holding a COP is a 'relevant person'.*

*The relevant person, being the reporting entity will be required to obtain Know Your Client ('KYC') records of its clients and its beneficial owners, maintain records of the financial transactions carried out in relation to the specified activities.*

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<sup>8</sup> Notification II –Notification No. F. No. P-12011/10/2023-ES Cell-DOR dated 9 May 2023

The PMLA does not define the term 'financial transaction'. Further, there is no threshold prescribed either for the financial transaction implying thereby that a record of all financial transactions irrespective of the quantum needs to be maintained.

While 'beneficial owner' is defined in the PMLA to mean an individual who ultimately owns or controls a client of a reporting entity, a minimum percentage of shareholding for beneficial ownership is not provided currently.

As per Notification II, any person carrying on the activities specified in Notification II shall be covered as a reporting entity.

It may be noted that any person assisting companies and LLPs to get formed/incorporated are covered but any person assisting firms, trusts, Association Of Persons, etc. in their formation/registration/incorporation are excluded. Further, any person acting as a director or company secretary is covered. Activities carried out by an employee on behalf of his employer are excluded. Directors are covered but company secretary on company's payroll may get excluded.

Generally, foreign companies having a wholly owned subsidiary in India, in order to meet the 'minimum two-shareholder' criteria as required under the Companies Act, a nominee individual shareholder is appointed. Such an individual will now be covered as a reporting entity. As such shareholders are not covered by the notification unless they are involved in any of the specified activities, but a nominee shareholder is specifically covered.

Any person providing a registered office, business address or accommodation, correspondence or administrative address for a company or a LLP or a trust is covered as a reporting entity. However, whether an email address also qualifies as a correspondence address is not clarified. Income tax practitioners providing their email address for correspondence on behalf of their clients while filing income tax returns in India may now be covered as reporting entities.

**DID YOU KNOW?**

1. As per the press release dated 25 May 2023, the monetary limit of exemption for leave encashment has been increased to INR 2.5 mn from INR 0.3 mn with effect from 1 April 2023.
2. The CBDT, vide Circular No. 7 dated 31 May 2023 has revised monetary limits to decide condonation of delay in filing return of income claiming refunds or carry forward of losses. The Circular specified the monetary limit upto which each income tax authority can deal with the condonation requests

Income-tax Authority	Monetary Limit per FY (In INR)
Principal Commissioner of Income Tax	Upto 5 mn
Chief Commissioner of Income Tax ('CCIT')	> 5 mn but not exceeding 20 mn
Principal CCIT	> 20 mn but not exceeding 30 mn
CBDT	> 30 mn

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](mailto:coe@jmpadvisors.in).

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