CORPORATE GOVERNANCE IN LISTED COMPANIES - NEW CLAUSE 49 OF THE EQUITY LISTING AGREEMENT- PART -II

II. BOARD OF DIRECTORS

A. Composition of Board

1. The Board of Directors of the company shall have an optimum combination of executive and non-executive directors with at least one woman director1 and not less than fifty per cent of the Board of Directors comprising non-executive directors.

2. Where the Chairman of the Board is a non-executive director, at least one-third of the Board should comprise independent directors and in case the company does not have a regular non-executive Chairman, at least half of the Board should comprise independent directors :

Provided that where the regular non-executive Chairman is a promoter of the company or is related to any promoter or person occupying management positions at the Board level or at one level below the Board, at least one-half of the Board of the company shall consist of independent directors.

Explanation: For the purpose of the expression "related to any promoter" referred to in sub-clause (2):
"(i) If the promoter is a listed entity, its directors other than the independent directors, its employees or its nominees shall be deemed to be related to it;
(ii) the promoter is an unlisted entity, its directors, its employees or its nominees shall be deemed to be related to it."

B. Independent Directors

1. For the purpose of the clause A, the expression 'independent director' shall mean a non-executive director, other than a nominee director of the company:

(a.) who, in the opinion of the Board, is a person of integrity and possesses relevant expertise and experience;

(b) (i) who is or was not a promoter of the company or its holding, subsidiary or associate company;
(ii) who is not related to promoters or directors in the company, its holding, subsidiary or associate company;

(c) apart from receiving director's remuneration, has or had no material pecuniary relationship with the company, its holding, subsidiary or associate company, or their promoters, or directors, during the two immediately preceding financial years or during the current financial year;

(d) none of whose relatives has or had pecuniary relationship or transaction with the company, its holding, subsidiary or associate company, or their promoters, or directors, amounting to two per cent or more of its gross turnover or total income or fifty lakh rupees or such higher amount as may be prescribed, whichever is lower, during the two immediately preceding financial years or during the current financial year;

(e) who, neither himself nor any of his relatives —

(i) holds or has held the position of a key managerial personnel or is or has been employee of the company or its holding, subsidiary or associate company in any of the three financial years immediately preceding the financial year in which he is proposed to be appointed;

(ii) is or has been an employee or proprietor or a partner, in any of the three financial years immediately preceding the financial year in which he is proposed to be appointed, of —

(A) a firm of auditors or company secretaries in practice or cost auditors of the company or its holding, subsidiary or associate company; or

(B) any legal or a consulting firm that has or had any transaction with the company, its holding, subsidiary or associate company amounting to ten per cent or more of the gross turnover of such firm;

(iii) holds together with his relatives two per cent or more of the total voting power of the company; or

(iv) is a Chief Executive or director, by whatever name called, of any non-profit organisation that receives twenty-five per cent or more of its receipts from the company, any of its promoters, directors or its holding, subsidiary or associate company or that holds two per cent or more of the total voting power of the company;

(v) is a material supplier, service provider or customer or a lessor or lessee of the company;

(f) who is not less than 21 years of age.

Explanation: For the purposes of the sub-clause (1):

(I) "Associate" shall mean a company which is an "associate" as defined in Accounting Standard (AS) 23, "Accounting for Investments in Associates in Consolidated Financial Statements", issued by the Institute of Chartered Accountants of India.

(ii) "Key Managerial Personnel" shall mean "Key Managerial Personnel" as defined in section 2(51) of the Companies Act, 2013.

(iii) "Relative "shall mean "relative "as defined in section 2(77) of the Companies Act, 2013 and rules prescribed there under.

2. Limit on number of directorships

(a) A person shall not serve as an independent director in more than seven listed companies.

(b) Further, any person who is serving as 'a whole time director in any listed company shall serve as an independent director in not more than three listed companies.

3. Maximum tenure of Independent Directors

The maximum tenure of Independent Directors shall be in accordance with the Companies Act, 2013 and clarifications/circulars issued by the Ministry of Corporate Affairs, in this regard, from time to time.

At present, an independent director shall hold office for a maximum term of 5 consecutive years.

4. Formal letter of appointment to Independent Directors

(a) The company shall issue a formal letter of appointment to independent directors in the manner as provided in the Companies Act, 2013.

(b) The terms and conditions of appointment shall be disclosed on the website of the company]

5. Performance evaluation of Independent Directors

(a) The Nomination Committee shall lay down the evaluation criteria for performance evaluation of independent directors.

(b) The company shall disclose the criteria for performance evaluation, as laid down by the Nomination Committee, in its Annual Report.

(c) The performance evaluation of independent directors shall be done by the entire Board of Directors (excluding the director being evaluated).

(d) On the basis of the report of performance evaluation, it shall be determined whether to extend or continue the term of appointment of the independent director.

6. Separate meetings of the Independent Directors

(a) The independent directors of the company shall hold at least one meeting in a year, without the attendance of non-independent directors and members of management. All the independent directors of the company shall strive to be present at such meeting.

(b) The independent directors in the meeting shall, inter alia:
(i) review the performance of non-independent directors and the Board as a whole;
(ii) review the performance of the Chairperson of the company, taking into account the views of executive directors and non-executive directors;
(iii) assess the quality, quantity and timeliness of flow of information between the company management and the Board that is necessary for the Board to effectively and reasonably perform their duties.

7. Familiarisation programme for Independent Directors

(a) The company shall familiarise the independent directors with the company, their roles, rights, responsibilities in the company, nature of the industry in which the company operates, business model of the company, etc., through various programmes.

(b) The details of such familiarisation programmes shall be disclosed on the company $ website and a web link thereto shall also be given in the Annual Report]

C. Non-executive Directors' compensation and disclosures

All fees/compensation, if any paid to non-executive directors, including independent directors, shall be fixed by the Board of Directors and shall require previous approval of shareholders in general meeting. The shareholders' resolution shall specify the limits for the maximum number of stock options that can be granted to. non-executive directors, in any financial year and in aggregate:

Provided that the requirement of obtaining prior approval of shareholders in general meeting shall not apply to payment of sitting fees to non-executive directors, if made within the limits prescribed under the Companies Act, 2013 for payment of sitting fees without approval of the Central Government:
Provided further that independent directors shall not be entitled to any stock option.

D. Other provisions as to Board and Committees

1. The Board shall meet at least four times a year, with a maximum time gap of one hundred and twenty days between any two meetings. The minimum information to be made available to the Board is given in Annexure X to the Listing Agreement.

2. A director shall not be a member in more than ten committees or act as Chairman of more than five committees across all companies in which he is a director. Furthermore, every director shall inform the company about the committee positions he occupies in other companies and notify changes as and when they take place.

Explanation:

(i) For the purpose of considering the limit of the committees on which a director can serve, all public limited companies, whether listed or not, shall be included and all other companies including private limited companies, foreign companies and companies under section 8 of the Companies Act, 2013 shall be excluded

(ii) For the purpose of reckoning the limit under this sub-clause, Chairmanship/ membership of the Audit Committee and the Stakeholders 'Relationship Committee alone shall be considered.

3. The Board shall periodically review compliance reports of all laws applicable to the company, prepared by the company as well as steps taken by the company to rectify in stances of non-compliances.

4. An independent director who resigns or is removed from the Board of the Company shall be replaced by a new independent director at the earliest but not later than the immediate next Board meeting or three months from the date of such vacancy, whichever is later.

5. Provided that where the company fulfils the requirement of independent directors in its Board even without filling the vacancy created by such resignation or removal, as the case may be, the requirement of replacement by a new independent director shall not apply.

6. The Board of the company shall satisfy itself that plans are in place for orderly succession for appointments to the Board and to senior management.

E. Code of Conduct

The Board shall lay down a code of conduct for all Board members and senior management of the company. The code of conduct shall be posted on the website of the company.

All Board members and senior management personnel shall affirm compliance with the code on an annual basis. The Annual Report of the company shall contain a declaration to this effect signed by the CEO.

The Code of Conduct shall suitably incorporate the duties of Independent Directors as laid down in the Companies Act, 2013.

An independent director shall be held liable, only in respect of such acts of omission or commission by a company which had occurred with his knowledge, attributable through Board processes, and with his consent or connivance or where he had not acted diligently with respect of the provisions contained in the Listing Agreement.

Explanation: For this purpose, the term "senior management" shall mean personnel of the company who are members of its core management team excluding Board of Directors. Normally, this would comprise all members of management one level below the executive directors, including all functional heads.

F. Whistle Blower Policy

1. The company shall establish a vigil mechanism for directors and employees to report concerns about unethical behaviour, actual or suspected fraud or violation of the company s code of conduct or ethics policy.

2. This mechanism should also provide for adequate safeguards against victimization of director(s)/'employee(s) who avail of the mechanism and also provide for direct access to the Chairman of the Audit Committee in exceptional cases.

3. The details of establishment of such mechanism shall be disclosed by the company on its website and in the Board's report.

LIFE CYCLE COSTING (LCC)

- At the start of any project, it is important to understand the costs involved
- Traditional methods simply look up start up costs, cash flow and profit or loss
- Focused primarily on the manufacturing stage of product life cycle

The term **'Life Cycle Cost'** has been defined as follows, "it includes the costs associated with acquiring, using, caring for and disposing of physical assets including the feasibility studies, research,design, development, production, maintenance, replacement and disposal well as support, training and operating costs generated by the acquisition use, maintenance and relplacement of permanent physical assets."

- Category of LCC Capital Assets:
  - Intial Cost
  - Operating Cost
  - Disposal Cost

Formula of LCC

Capital + Lifetime perating cost + Lifetime maintenance cost + Disposal cost - residual value

Example: A Company is planning a new product. Market research information suggests that the product should sell 10,000 units at RM21/unit. The company seeks to make a mark-up of 40% product cost. It is estimated that lifetime costs of the product will be as follows:

Design and development costs RM50,000

Manufacturing cost RM10/unit

End of life cost RM20,000

Calculate the original life cycle cost per unit?

Answer:

LCC/unit = (RM50,000 + (10,000 x RM10) + RM20,000) /10,000 unit

= RM17

- Assists management to smartly manage total cost throughout product's life cycle.
- To identify areas in which cost reduction efforts are likely to more effective.
- To estimate the cost impact of various design's and supports options.

- **Ther are two important point:**
  - The focus on the product cost
  - The inclusion of all upstream and downstream cost
- **A product life cycle may be clssified into three broad stages,**
  - Planning and Design
  - Manufacturing and Sales
  - Sevice and Abandonment

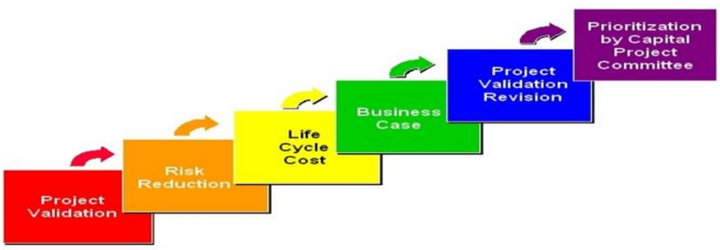
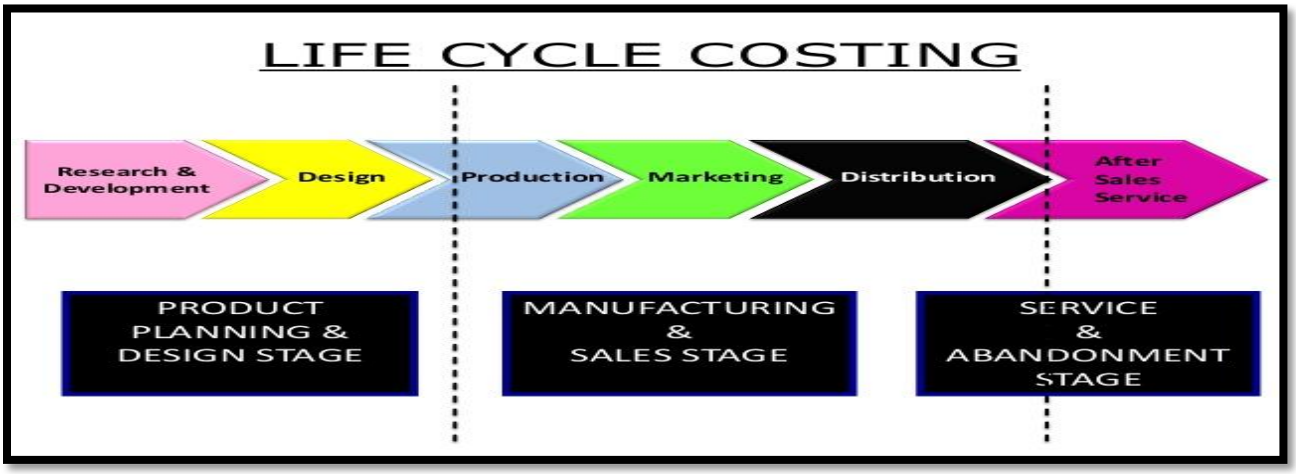
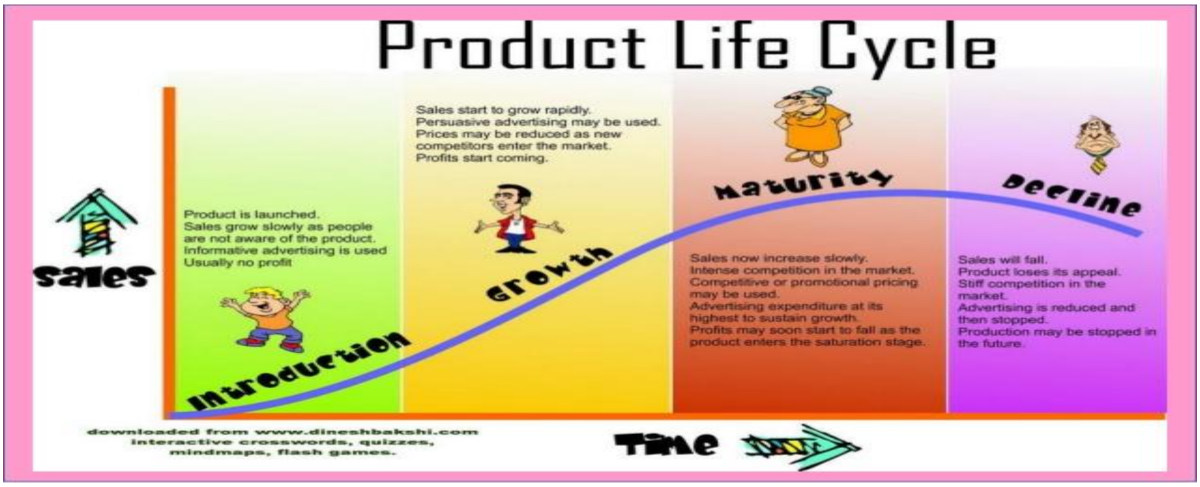
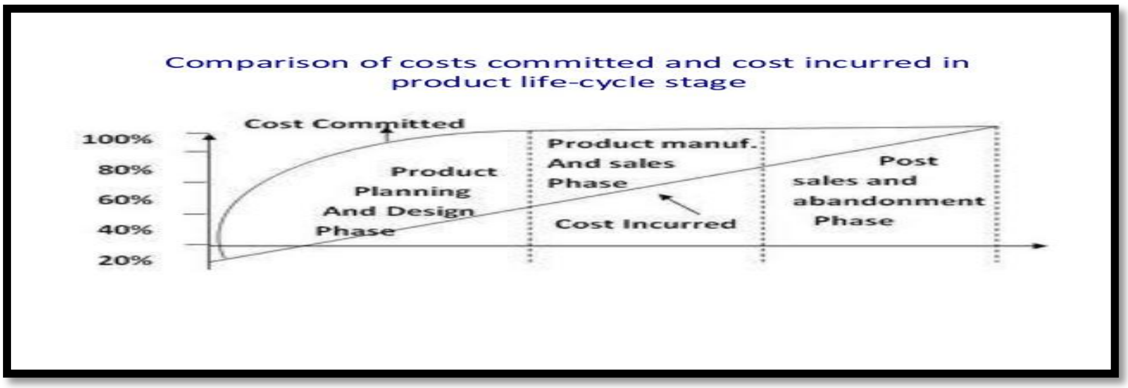


Figure 1 → Capital Project Development Process Steps





- **Costs are committed and incurred at very different times. A committed cost is a cost that will be incurred in the future because of decisions that have already been made. Costs are incurred only when a resource is used.**



- **Improve forecasting:**
    - The application of LCC technique allows the full cost associated with a procurement to be estimated more accurately.
- **Improved awareness:**
    - Provide management with an improved awareness of the factors that drive cost and the resources required by the purchase.
- **Performance trade-off against cost**
    - LCC techniques not only focus on cost but also consider other factors like quality of the goods and level of service to be provided.

- **Time Consuming:**
    - Life cycle costing analysis is too long because of changes of new technology.
- **Costly:**
    - The longer the project life time, the more operating cost will be incurred.
- **Technology:**
    - Technologies always change day to day.

<u>We can explain more clearly With the help of a case study</u>

Polaris, a company engaged in Decision Support System (DSS) is examining the profitability and pricing policies of three of its recent engineering software packages:

- EE-46: package for electrical engineers
- ME-83: package for mechanical engineers
- IE-17: package for industrial engineers

Summary details on each package over their two-year "infancy-to-grave" product lives are as follows:

		Number of Units Sold	
Package	**Selling Price**	**Year I**	**Year 2**
EE-46	₹ 2,500	2,000	8,000
ME-83	3,000	2,000	3,000
IE-17	2,000	5,000	3,000

Assume that no inventory remains on hand at the end of Year 2.

Polaris is deciding which product lines to emphasize. In the past two years, profitability has been mediocre. Polaris is particularly concerned with the increase in R&D costs. An analyst pointed out that for one of its most recent packages (IE-17), major efforts had been made to reduce R & D costs.

Praveen, the engineering software manager, decides to collect the following life-cycle revenue and cost information for the EE-46, ME-83, and IE-17 packages:

	EE-46		ME-83		IE-17	
	Year 1	**Year 2**	**Year 1**	**Year 2**	**Year 1**	**Year 2**
Revenues (₹ 000s)	₹ 5,000	₹ 20,000	₹ 6,000	₹ 9,000	₹ 10,000	₹ 6,000
Costs (₹ 000s)						
R & D	7,000	0	4,500	0	2,400	0
Design of product	1,850	150	1,100	100	800	160
Manufacturing	750	2,250	1,050	1,050	1,430	650
Marketing	1,400	3,600	1,200	1,500	2,400	2,080
Distribution	150	600	240	360	600	360
Customer service	500	3,250	450	1,050	2,200	3,880

Required:

(i) How does a product life-cycle income statement differ from a conventional income statement? What are the benefits of using a product life-cycle reporting format?

(ii) Present a product life-cycle income statement for each software package. Which package is the most profitable and which is the least profitable? Ignore the time value of money.

(iii) How do the three software packages differ in their cost structure (the percentage of total costs in each cost category)?

Answer:

(i) A life-cycle income statement traces revenue and costs of each individual software package from its initial research and development to its final customer servicing and support. The two main differences from a conventional income statement are:

a. Costs incurred in different calendar periods are included in the same statement.

b. Costs and revenue of each package are reported separately rather than aggregated into companywide categories.

The benefits of using a product life-cycle report are:

a. The full set of revenues and costs associated with each product becomes visible.

b. Differences among products in the percentage of total costs committed at early stages in the life cycle are highlighted.

c. Interrelationships among business function cost categories are highlighted.

(ii)

	EE-46		ME-83		IE-17	
Revenue (₹ 000s)		₹25,000		₹15,000		₹ 16,000
Costs (₹ 000s)						
Research & development	₹ 7,000		₹ 4,500		₹ 2,400	
Design	2,000		1,200		960	
Production	3,000		2,100		2,080	
Marketing	5,000		2,700		4,480	
Distribution	750		600		960	
Customer service	3,750	21,500	1,500	12,600	6,080	16,960
Operating income (₹ 0,000s)		₹ 3,500		₹ 2,400		₹ (960)

Rankings of the three packages on profitability (and relative profitability) are:

Operating income $\qquad\qquad$ $\dfrac{\text{Operating income}}{\text{Revenue}}$

Operating income

1. EE-46 : ₹ 35,00,000
2. ME-83 : ₹ 24,00,000
3. IE-17 : ₹ (9,60,000)

1. ME-83:16.0%
2. EE-46 :14.0%
3. IE-17 : (6.0%)

The EE-46 and ME-83 packages should be emphasized, and the IE-17 package should be de-emphasized. It is interesting that IE-17 had the lowest R&D costs but was the least profitable. Polaris should evaluate whether reducing R&D costs contributed in any way to IE-17's poor performance.

(iii) The cost structures of the three software packages are:

	EE-46	ME-83	IE-17
Research & Development	32.5%	35.7%	14.1%
Design	9.3	9.5	5.7
Production	14.0	16.7	12.3
Marketing	23.3	21.4	26.4
Distribution	3.5	4.8	5.7
Customer service	17.4	11.9	35.8
	100.0%	100.0%	100.0%

The major differences are:

a. EE-46 and ME-83 have over 30% of their costs in the R&D/product design categories, compared to less than 15% (14.1%) for IE-17.

b. IE-17 has 35.8% of its costs in the customer-service category, compared to 17.4% for EE-46 and 11.9% for ME-83.

There are several explanations for these differences:

a. EE-46 and ME-83 differ sizably from IE-17 in their R&D/product design intensity. For example, EE-46 and ME-83 may require considerably (a) more interaction with users, and (b) more experimentation with software algorithms than does IE-17.

b. The software division should have invested more in the R&D/product design categories for IE-17.

WHAT IS CAPITAL GAINS

(A) Charging sections - Sections 45, 46 and 46A

The charging section explains the subject matter of taxation – i.e. which income will be taxed and classified under which head. For income taxable under the heads, charging section is section 15 of the Income-tax Act, 1961 ("the Act"). For income from house property, it is section 22, The charging sections for business income and income from other sources are sections 28 and 56 respectively. Thus, there is one charging section for each head of income for salaries, income from house property, business income and income from other sources. However, for capital gains, as held in certain judicial decisions, there are three independent and separate charging sections:

(i) Section 45 - Capital gains

(ii) Section 46 - Capital gains on distribution of assets by companies in liquidation

(iii) Section 46A - Capital gains on purchase by company of its own shares or other securities

Section 45 is the general provision while sections 46 and 46A are special provisions.

The following incomes are taxable as 'capital gains':

(a) Any profits and gains arising from the transfer of a capital asset effected in the previous year [Section 45(1)] including those referred to in sub-sections (2) to (5) of,section 45

(b) Any profits and gains arising from the receipt of any money or other assets under an insurance from an insurer on account of damage to, or destruction of, any capital asset, as a result of (i) flood, typhoon, hurricane, cyclone, earthquake or other convulsion of nature; or (ii) riot or civil disturbance; or (iii) accidental fire or explosion; or (iv) action taken by an enemy or in combating an enemy (whether with or without declaration of war) - [Section 45(1A)]

(c) Capital gains in respect of any money or other assets (market value of assets on date of distribution) received by shareholder of a company from the company on its liquidation as reduced by deemed dividend u/s 2(22)(c) - [Section 46(2)]

(d) Difference between (i) value of consideration received by shareholder or holder of specified securities from company on buyback of its own shares or other specified securities; and (ii) cost of acquisition [Section 46A]

(B) Distinction between capital gains and business income

The following table shows the broad distinguishing features of business income versus capital gains:

Business income	Capital gains
The subject matter of sale less the expenditures (both direct and indirect) is taxable as business income.	Sale consideration less cost of acquisition/indexed cost of acquisition is taxable as capital gain /long term capital gain.
Acquisition or payment towards stock in trade in violation of section 40A(3) would result in disallowance of expenditure. However, exceptions are given in rule 6DD.	Acquisition of capital asset is not regulated as regards the mode of payment and the acquisition could be by any mode. Even where no expenditure is incurred but inherited, the fair market value or cost to the previous owner could be adopted for computing capital gains.
The assessee can claim expenses incurred such as administrative, interest and other incidental expenses while computing income.	The assessee can claim only expenditures incurred wholly and exclusively in connection with the transfer such as brokerage and arrive at net consideration.
Withholding of stock in trade over a period of time has no consequence in deciding the taxable income. However, if held for too long a period of time< a question would arise whether it really was held for its stated purpose - Le. as stock-in-trade and not as a capital asset	A capital asset held for more than 36 months is eligible for indexation benefit and concessional rate of tax. In the case of shares and securities, the period of holding is 12 months for treating the asset as long term.
Income from business is taxable in the regular manner at normal rates of tax.	Income from capital gains is taxable at flat rate of tax subject to certain reduction if the total income (excluding capital gains) is below taxable limit.
Deduction under Chapter VI-A could be claimed.	No deduction under Chapter VI-A could be claimed against long term capital gains.
Loss if any could be set off against any income except salary.	Loss under the head "Capital gains" is eligible for set off only against capital gains. Long-term capital loss cannot be set off against short-term capital gain.

Replacement of stock-in-trade will not reduce taxable income	Reinvestment of capital gain or net consideration as the case may be would aid in reducing taxable capital gain.
Depreciation on assets could be claimed against business income.	No such deduction could be claimed though in reality expenditures are incurred for maximizing realization value of capital asset.
Discontinued business loss carried forward could be set off against business income.	Loss under the head Capital gains carried forward could be set off only against capital gains.
Business loss can be set off even against speculation business income. However, speculation business loss cannot be set off against any other income except speculation income.	Capital gain is available for set off of loss from business/profession. But Loss under the head Capital gains cannot be set off against income under any head including speculation income. Loss under the head "Capital gains" can be set off only against capital gain.

Immovable property: A transaction of purchase or sale of land cannot be assumed, without more, to be an adventure in the nature of trade. Further, mere ownership of an immovable property, even if purchased from a source which was originally employed in the money-lending business, does not automatically make such property a part of such business. Therefore, merely because a money-lender acquires an immovable property 'in lieu of an advance' made by it, such immovable property cannot straightaway assume the character of stock-in-trade, unless it is shown that it was, in fact, converted into stock-in-trade. Thus, profits realised from sale of such immovable property is assessable as capital gains and not as business income.

In CIT v. Simpson General Finance Co. Ltd [1998] 96 Taxman 172 (Mad.) the assessee acquired land from an allied concern and retained it for more than a decade. Later, the lands were sold to parent company and to allied concerns. A small portion was also sold to an outsider. The assessee claimed that the transfer of land to parent company is not a transfer as per section 47(v) whereas the Assessing Officer wanted to tax the gain under **the** head 'Business/profession'. The Court held (i) that the assessee acquired land from allied concern and retained it for more than a decade; (ii) sale of land to parent company is also a sale to allied concern; (iii) from the conduct of assessee it is clear that the acquisition of land was not for business purpose like stock-in-trade; and (iv) the price at which the lands in question were sold was not at market price. These evidences prove that the assessee was not a dealer in land and the transfer was only relating to a capital asset and the transaction with the parent company is covered by section 47(v) which applies to transfer of capital assets (not stock-in-trade) and hence any gain arising from transfer (other than transfer to parent company) is taxable under the head 'Capital gains'.

(C) Conditions to be fulfilled for taxing capital gains

According to section 45(1), any profits or gains arising from the transfer of a capital asset effected in the previous year shall, save as otherwise provided in sections 54, 54B, 54D, 54E, 54EA, 54EB, 54F, 54G and 54H, be chargeable to income-tax under the head "Capital gains", and shall be deemed to be the income of the previous year in which the transfer took place.

In Asstt. CIT v. Dr. B.V. Raju [2012] 135 ITD 1 (Hyd.) (SB), the ITAT held that for attracting charge to tax under the head 'Capital gain'; the following conditions are necessary to be fulfilled, viz.:

(a) There must be a capital asset;
(b) There should be a transfer of the capital asset other than an exempted transfer;
(c) The capital asset should be something which can be acquired by paying a cost i.e. the cost of acquisition of the capital asset should be determinable.
(d) There must be accrual of consideration for transfer of capital asset.

The following points are important:

- The above conditions apply in the context of the general charging provisions in section 45(1) and not in the context of special charging provisions in sections 45(1A), 46 and 46A. In cases of income chargeable to tax under sections 45(1A), 46 and 46A, it is sufficient that conditions under those sections be satisfied even though one or more of the conditions in (a) to (d) above are not fulfilled.
- Any capital gain falling within the ambit of section 45(1) will be out of the tax net if :
  (i) asset transferred is an 'excluded capital asset'

  (ii) transfer is an exempted transfer under section 47

  (iii) capital gain is exempt from tax under section 10(3 7)/10(38)

  (iv) capital gain is exempt under sections 54 to 54H

  (v) cost of acquisition is not capable of being determined

  (vi) consideration is not capable of being determined or calculated - this requirement applies upto A.Y. 2012-13. With effect from A.Y. 2013-14, if consideration is not capable of being determined or calculated, fair market value shall be deemed to be the consideration.

(D) Tax-free capital gains

In the following cases, income from Capital gains is specifically exempted:

(i) Income from transfer of a unit of the Unit Scheme, 1964 referred to in Schedule I to the Unit Trust of India (Transfer of Undertaking and Repeal) Act, 2002 and where the transfer of such asset takes place on or after 1-4-2002.

(ii) Capital gains of a political party subject to provisions of section 13A of the IT Act, 1961.

(iii) In the case of an individual or HUF, capital gains arising from the transfer of agricultural land, where such land is situated in any area falling within the jurisdiction of a municipality or a cantonment board having population of at least 10,000 or in any area within such distance, not being more than 8 kms., from the local limits of any municipality or cantonment board. Such land should have been used for agricultural purposes during the period of two years immediately preceding the date of transfer. Further, such transfer should be by way of compulsory acquisition under any law and the said capital gains should have arisen from the compensation received on or after 1st April, 2004.

(iv) Capital gains arising from the transfer of a long-term capital asset, being an equity share in a company or unit in an equity oriented fund where such a transaction is chargeable to securities transaction tax and takes place on or after 1st October, 2004.

(v) Clause (43) inserted in section 10 by the Finance Act, 2008 exempts from tax "any amount received by an individual as a loan, either in lump sum or in instalment, in a transaction of reverse mortgage".

(e) Whether situs/location of a capital asset matters for taxability of capital gains?

The situs/location of capital asset matters only for non-resident assessees and not ordinarily resident assessees (i.e. resident but not ordinarily resident assessees). In the cases of these assessees, if capital asset located outside India is transferred outside India and sale proceeds are received outside India, no taxability to capital gains arises in view of section 5 of the Act. Such assessees will be liable to be taxed under section 9(1)(i) in respect of capital gains accruing or arising "through the transfer of any capital asset situate in India".

(i) Taxability of "indirect transfers" of any capital asset situate in India - Legislative History

The above section along with sections 2(14) (definition of capital asset), 2(47) (definition of transfer) and section 195(1)(TDS on payments to non-residents) were Authoritatively interpreted by the Supreme Court in Vodafone International Holdings B.V. v. UOI [2012] 17 taxmann.com 202. The facts of the case involved a transaction of "indirect transfer" of a capital asset situate in India whereby the ultimate foreign company which held an Indian subsidiary through a chain of foreign subsidiaries transferred outside India to another foreign company the shares of a foreign subsidiary which held the shares of the Indian subsidiary. Revenue sought to invoke section 9(1)(i) of the Act to tax the resulting capital gains since one of the limbs of section 9(1)(i) provided for taxing capital gains arising "through the transfer of any capital asset situate in India". The Court ruled in favour of the assessee and held as under:

- A controlling interest is an incident of ownership of shares in a company, something which flows out of the holding of shares. A controlling interest is, therefore, not an identifiable or distinct capital asset independent of the holding of shares. The control of a company resides in the voting power of its shareholders and shares represent an interest of a shareholder which is made up of various rights contained in the contract embedded in the Articles of Association. The right of a shareholder may assume the character of a controlling interest where the extent of the shareholding enables the shareholder to control the management. Shares, and the rights which emanate from them, flow together and cannot be dissected.
- A legal right is an enforceable right. Enforceable by a legal process. The question is what is the nature of the "control" that a parent company has over its subsidiary. It is not suggested that a parent company never has control over the subsidiary. For example, in a proper case of "lifting of corporate veil", it would be proper to say that the parent company and the subsidiary form one entity. But barring such cases, the legal position of any company incorporated abroad is that its powers, functions and responsibilities are governed by the law of its incorporation. No multinational company can operate in a foreign jurisdiction save by operating independently as a "good local citizen". A company is a separate legal persona and the fact that all its shares are owned by one person or by the parent company has nothing to do with its separate legal existence. If the owned company is wound up, the liquidator, and not its parent company, would get hold of the assets of the subsidiary. In none of the authorities have the assets of the subsidiary been held to be those of the parent unless it is acting as an agent. Thus, even though a subsidiary may normally comply with the request of a parent company it is not just a puppet of the parent company. The difference is between having power or having a persuasive position. Though it may be advantageous for parent and subsidiary companies to work as a group, each subsidiary will look to see whether there are separate commercial interests which should be guarded. When there is a parent company with subsidiaries, is it or is it not the law that the parent company has the "power" over the subsidiary. It depends on the facts of each case. For instance, take the case of a one-man company, where only one man is the shareholder perhaps holding 99% of the shares, his wife holding 1%. In those circumstances, his control over the company may be so complete that it is his alter ego. But, in case of multinationals it is important to realise that their subsidiaries have a great deal of autonomy in the country concerned except where subsidiaries are created or used as a sham. Of course, in many cases the courts do lift up a corner of the veil but that does not mean that they alter the legal position between the companies. The directors of the subsidiary under their Articles are the managers of the companies. If new directors are appointed even at the request of the parent company and

even if such directors were removable by the parent company, such directors of the subsidiary will owe their duty to their companies (subsidiaries). They are not to be dictated by the parent company if it is not in the interests of those companies (subsidiaries). The fact that the parent company exercises shareholder's influence on its subsidiaries cannot obliterate the decision-making power or authority of its (subsidiary's) directors. They cannot be reduced to be puppets. The decisive criteria is whether the parent company's management has such steering interference with the subsidiary's core activities that subsidiary can no longer be regarded to perform those activities on the authority of its own executive directors. Applying the test of enforceability, influence/persuasion cannot be construed as a right in the legal sense. One more aspect needs to be highlighted. The concept of "de facto" control, which existed in the Hutchison structure, conveys a state of being in control without any legal right to such state. This aspect is important while construing the words "capital asset" under the income-tax law. As stated earlier, enforceability is an important aspect of a legal right.

- Applying the test of enforceability, influence / persuasion of parent company over its subsidiary cannot be construed as a right in the legal sense since capital asset covers 'property' of any description and a right has to be legally enforceable to be 'property' and 'capital asset' within the meaning of section 2(14).
- On transfer of shares of a foreign company to a non-resident offshore, there is no transfer of shares of the Indian Company, though held by the foreign company, in such a case it cannot be contended that the transfer of shares of the foreign holding company, results in an extinguishment of the foreign company control of the Indian company and it also does not constitute an extinguishment and transfer of an asset situate in India. Transfer of the foreign holding company's share off-shore, cannot result in an extinguishment of the holding company right of control of the Indian company nor can it be stated that the same constitutes extinguishment within the meaning of section 2(47) and transfer of an asset/management and control of property situated in India-Vodafone International Holdings B.V. v. UOI [2012] 17 taxmann.com 202 (SC).
- The Legislature has not used the words "indirect transfer" in section 9(1)(i). If indirect transfer of a capital asset is read into section 9(1)(i) then the words capital asset situate in India would be rendered nugatory. Similarly, the words underlying asset do not find place in section 9(1)(i). Thus, the words directly or indirectly in section 9(1)(i) go with the income and not with the transfer of a capital asset (property). The Direct Tax Code (DTC) Bill, 2010 proposes to tax income from transfer of shares of a foreign company by a non-resident, where the fair market value of the assets in India, owned directly or indirectly, by the company, represents at least 50% of the fair market value of all assets owned by the company. This proposal indicates in a way that indirect transfers are not covered by the existing section 9(1)(i) of the Act. [Per CJI S.H. Kapadia]. On a comparison of section 64 and section 9(1)(i) what is discernible is that the Legislature has not chosen to extend section 9(1)(i) to "indirect transfers". - Vodafone International Holdings B.V. v. UOI [2012] 17 taxmann.com 202 (SC).
- Section 195 would apply only if payments made from a resident to another non-resident and not between two non-residents situated outside India - Vodafone International Holdings B.V. v. UOI [2012] 17 taxmann.com 202 (SC).

The Finance Act, 2012 made retrospective amendments w.r.e.f. 1-4-1962 to sections 2(14) (definition of capital asset), 2(47)(definition of transfer), section 9(1)(i) ("income deemed to accrue or arise in India") and section 195(1) to overcome the decision of the Supreme Court in Vodafone (supra). These retrospective amendments are as under :

- Explanation has been inserted below section 2(14) (definition of 'capital asset') which clarifies that "property" includes and shall be deemed to have always included any rights in or in relation to an Indian company, including rights of management or control or any other rights whatsoever. While the new Explanation makes "any rights in or in relation to an Indian company, including rights of management or control or any other rights whatsoever" a distinct and independent capital asset-distinct from the shares from which they are derived, it does nothing to change the Supreme Court's interpretation of the word 'right'. A mere power of persuasion cannot be a "right" legal enforceability is the soul of a right. It appears that these retrospective amendments do nothing to change the definition of 'right' to include power of persuasion of a holding company over its subsidiary.
- Explanation below section 2(47) (definition of "transfer") renumbered as Explanation 1 and new Explanation 2 inserted with retrospective effect from 1-4-1962 to clarify that '"transfer" includes and shall be deemed to have always included disposing of or parting with an asset or any interest therein, or creating any interest in any asset in any manner whatsoever, directly or indirectly, absolutely or conditionally, voluntarily or involuntarily, by way of an agreement (whether entered into in India or outside India) or otherwise, notwithstanding that such transfer of rights has been characterised as being effected or dependent upon or flowing from the transfer of a share or shares of a company registered or incorporated outside India'.
- Two new Explanations Explanation 4 and Explanation 5 inserted in clause (i) of sub-section (1) of section 9 with retrospective effect from 1-4-1962. New Explanation 3 seeks to clarify that the expression "through" shall mean and include and shall be deemed to have always meant and included "by means of", "in consequence of" or "by reason of".
- Section 195(1) has been amended with retrospective effect from 1-4-1962 to clarify that obligation to comply with sub-section (1) and to make deduction thereunder applies and shall be deemed to have always applied and extends and shall be deemed to have always extended to all persons, resident or non-resident, whether or not the non-resident has:—
  (a) a residence or place of business or business connection in India; or
  (b) any other presence in any manner whatsoever in India.

The Explanatory Memorandum to the Finance Bill, 2012 explains the rationale for the above amendments as follows:

"Section 9 of the Income-tax provides cases of income, which are deemed t**o accrue or arise in India.** This is a legal fiction created to tax income, which may or may not arise in India and would not have been taxable but for the deeming provision created by this section. Sub-section (1)(i) provides a set of circumstances in which income accruing or arising, directly or indirectly, is taxable in India. One of the limbs of clause (i) is income accruing or arising directly or indirectly through the transfer of a capital asset situate in India. The legislative intent of this clause is to widen the application as it covers incomes, which are accruing or arising directly or indirectly. The section codifies source rule of taxation wherein the state where the actual economic nexus of income is situated has a right to tax the income irrespective of the place of residence of the entity deriving the income. Where corporate structure is created to route funds, the actual gain or income arises only in consequence of the investment made in the activity to which such gains are attributable and not the mode through which such gains are realized. Internationally this principle is recognized by several countries, which provide that the source country has taxation right on the gains derived of offshore transactions where the value is attributable to the underlying assets.

Section 195 of the Income-tax Act requires any person to deduct tax at source before making payments to a non-resident if the income of such non-resident is chargeable to tax in India. "Person", here, will take its meaning from section 2 and would include all persons, whether resident or non-resident. Therefore, a non-resident person is also required to deduct tax at source before making payments to another non-resident, if the payment represents income of the payee non-resident, chargeable to tax in India. There are no other conditions specified in the Act and if the income of the payee non-resident is chargeable to tax, then tax has to be deducted at source, whether the payment is made by a resident or a non-resident. Certain judicial pronouncements have created doubts about the scope and purpose of sections 9 and 195. Further, there are certain issues in respect of income deemed to accrue or arise where there are conflicting decisions of various judicial authorities."

(ii) Taxability of "Indirect transfers" - Legal provisions

Explanation 5 inserted by the Finance Act, 2012 in section 9(1)(i) clarifies that an asset or capital asset, being any share or interest in a company or entity registered or incorporated outside India shall be deemed to be situated in India if the share or interest derives, directly or indirectly, its value substantially from the assets located in India. The existing provisions related to indirect transfers are so widely worded that even if a single share (constituting less than 1% of total shareholding) of a foreign company having substantial assets in India is transferred outside India, then the gains arising on such a transfer, would be taxable in India. That would lead to undue hardship considering the fact that a single shareholder may not be in the know of all the global assets of the company. In view of this, the Expert Committee under the Chairmanship of Dr. Parthasarathi Shome had recommended that transfer of small shareholdings in a foreign company should not be subject to undue hardship as it does not result in the transfer of a controlling interest in the Indian assets. The Committee recommended threshold exemption to give relief to small shareholders of foreign company .The Committee had also recommended that the law must clarify as to when it can be said that the share or interest derives its value substantially from the assets located in India. In other words, law must define the word 'substantially' used in Explanation 5.

INTERPRETATIVE RULES OF CETA

The Central Excise Tariff Act, 1985, contains a set of six general rules for the interpretation of the Tariff Schedule. These rules for interpretation are identical to those contained in the HSN (Harmonised System of Nomenclature). Accordingly, the Explanatory Notes issued for these interpretative rules under HSN are also relevant for Central Excise purposes. However, the Supreme Court in the case of CCE v. K.W.H. Heliplastics Ltd. – 1998 (97) E.L.T. 385 (S.C.), held that classification of goods under a particular heading depends upon description, purpose and use of goods. Therefore, before resorting to the interpretative rules, it is required to look at the nature, description, purpose and usage of the goods. The rules to be applied sequentially. Following are the steps of classification of a product:

Rule 1: Titles are for reference: It provides that the titles of sections, chapters and sub-chapters are provided for ease of reference and headings along cannot be used for classification. The determination as to where the goods fall would be dependent on the relevant section and chapter notes contained in the tariff.

Rules for interpretation are not invokable if the section and chapter notes clearly determine the classification.

Example - Mr. Sen manufactured wooden table. There is no ambiguity or confusion while classifying the said product. Hence, the said product can be classified as wooden table.

Case Law – In Subhash Photographics v. U.O.I. -1992 (62) E.L.T. 270 (Bom.), it was held that classification has to be determined according to the terms of the headings read with the relevant Chapter Notes and Rules of Interpretation.

Rule 2(a): Principle for classification of incomplete or unfinished goods — It specifies that if the incomplete or unfinished goods have the essential characteristics of the complete or finished goods, then such goods would be classified in the same heading as the complete goods. Complete or finished goods would cover goods removed in unassembled or disassembled form.

Example – Motor vehicle not yet fitted with wheels, battery or tyres, Bicycles without saddles and tyre – but not forgings and castings.

Rule 2(b): Mixture or Combinations of goods falls under different classifications — Any reference in a heading to a material or substance shall be taken to include a reference to mixtures or combinations of that material or substance with other materials or substances.

Any reference to goods of a given material or substance shall be taken to include a reference to goods consisting wholly or partly of such material or substance. The classification of goods consisting of more than one material or substance shall be according to the principles of rule 3.

Example – 'Article of gold' will include an article which is made partly of gold.

Rule 3(a): If ambiguity persists, find out which heading is specific and which heading is more general. Prefer specific heading.

Example – VIP bag is a 'Plastic Article' in common parlance, but if there is a specific entry 'suitcases', that entry will prevail over general entry 'plastic articles'.

Rule 3(b): If problem is not resolved by Rule 3(a), find which material or component is giving 'essential character' to the goods in question.

Example - if a set consists of drawing instruments (90.17), pencil (96.06) and pencil sharpener (82.14), put up in a leather case (4201.90); the set will be classifiable under 90.17 i.e., drawing instrument.

Rule 3(c): If both are equally specific, find which comes last in the numerical order in the Tariff and take it.

Example – Electrical insulating self adhesive tape can be classified as self adhesive tape under 39.19 and electrical insulator under 85.46. Hence, later serial number, i.e. 85.46 will prevail.

Rule 4: In case where the goods cannot be classified based on the above principles, they would be classified under the head appropriate to the goods to which they are most akin.

Case Law – In the case of Commissioner of Central Excise, Mumbai v. Garware Polyster Ltd. – 2004 (164) E.L.T. 344 (Tri.-Mumbai), in which photographic film waste having base of polyester was classified under 39.15.The base material being the polyester film, impugned goods most akin to waste/ scrap classifiable under heading 39.15 of Central Excise Tariff Act, 1985.

Rule 5: Packing material is to be classified in the heading in which the goods packed are classified.

Example – Packing material used as cases for camera classifiable as camera product.

Case Law – In the case of Print-O-Pack v. CCE (2012) 275 E.L.T. 95 (CESTAT), assessee was placing sugar cone (ice-cream cone) in aluminium foil cone. It was held that aluminium foil cone is used only as packing and entire goods will be classified as 'ice-cream cone' only.

Rule 6: Goods compared at the same level of sub-headings — The classification of goods in the subheadings of a heading shall be determined according to the terms of those sub-headings and any related sub-heading Notes and, mutatis mutandis, to the above rules, on the understanding that only sub-headings at the same level are comparable. For the purposes of this rule the relative Section and Chapter Notes also apply, unless the context otherwise requires.

Case Law – In case of CCEx., Bhubaneshwar v. Champdany Industries Ltd. – 2009 (241) E.L.T. 481 (SC), the Apex Court held that in various decisions Supreme Court has observed that when specific heading exists, goods should not be classified under a residuary heading and such principle hardened into a rule of law by reason of consistent view taken by the Court.

Basel-II and RBI Guidelines (Operational Risk)

Operational Risk

Operational risk arises from faulty business practices or when buildings, equipment, and other property required to run the business are damaged or destroyed. For instance, banks in the vicinity of the World Trade Center suffered considerable losses as a result of the terrorist attacks on September, 11, 2001, which knocked out power and communications in the surrounding area. Barings Bank collapsed because its audit controls did not detect the calamitous losses suffered by its rogue trader, Nick Leeson, early enough to prevent its collapse.

Many types of operational risk, such as the destruction of property, are covered by insurance. However, good management is required to prevent losses due to faulty business practices, since such losses are not insurable. Critics argued that the stress tests were devised so that most banks would pass, since widespread failure could hurt the economy. For instance, there was no test of how well banks would have done if Greece defaulted on its bonds, which many investors thought was a real possibility.

Basel- II

Basel-II is the second of the Basel Accords, which are recommendations on banking laws and regulations issued by the Basel Committee on Banking Supervision. The purpose of Basel-II, which was initially published in June 2004, is to create an international standard that banking regulators can use when creating regulations about how much capital banks need to put aside to guard against the types of financial and operational risks banks face. Advocates of Basel-II believe that such an international standard can help protect the international financial system from the types of problems that might arise should a major bank or a series of banks collapse. In practice, Basel-II attempts to accomplish this by setting up rigorous risk and capital management requirements designed to ensure that a bank holds capital reserves appropriate to the risk the bank exposes itself to through its lending and investment practices. Generally speaking, these rules mean that the greater risk to which the bank is exposed, the greater the amount of capital the bank needs to hold to safeguard its solvency and overall economic stability.

The final version of the committee aims at:

1. Ensuring that capital allocation is more risk sensitive.
2. Separating operational risk from credit risk, and quantifying both.
3. Attempting to align economic and regulatory capital more closely to reduce the scope for regulatory arbitrage.

While the final accord has largely addressed the regulatory arbitrage issue, there are still areas where regulatory capital requirements will diverge from the economic.

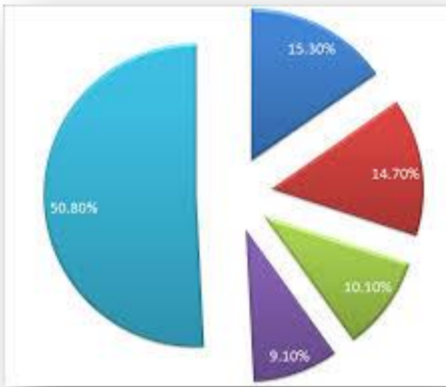
Basel-II has largely left unchanged the question of how to actually define bank capital, which diverges from accounting equity in important respects The Basel-I definition, as modified up to the present, remains in place.

Basel-II uses a "three pillars" Concept

(1) Minimum capital requirements (addressing risk),
(2) Supervisory review and
(3) Market discipline.

The Basel-I accord dealt with only parts of each of these pillars. For example, with respect to the first Basel-II pillar, only one risk, credit risk, was dealt within a simple manner while market risk was an afterthought; operational risk was not dealt with at all.

PURCHASE OF SHARES IN LOTS



Following are the balances in the Balance Sheet of Blue Ltd. and Green Ltd.

- As on 31.03.2014 Equity Share Capital (₹10): Blue Ltd. ₹80,000; Green Ltd. ₹1,00,000.
- As on 31.03.2014 shares of Green Ltd. held by Blue Ltd. is ₹99,000.
- Profit and Loss A/c balances as on 31.03.2014 of Blue Ltd. is ₹22,000 and Green Ltd. is ₹30,000.
- Net Profit during 2013-14 included in above were : Blue Ltd. ₹18,000; Green Ltd. ₹9,000.
- Both the companies have proposed a dividend of 10% which is yet to be recorded.
- On 01.04.2013, Blue Ltd. was formed and on the same day it acquired 4,000 shares of Green Ltd. at ₹55,000.
- On 31.07.2013, 10% dividend was received from Green Ltd. and also bonus shares at 1:4 were received. The dividend was credited to P&L A/c.
- On 31.08.2013 Blue Ltd. purchased another 3,000 shares of Green Ltd. at ₹44,000.

Analyse the profit.

Company Status	Date of Acquisition
Holding Co.– Blue Ltd. **Subsidiary Co.– Green Ltd.**	**Lot 1 4,000 Shares = 01.04.13** **Bonus 1,000 Shares 31.07.13** **Lot 2 3,000 Shares = 31.08.13**

Period	No. of Shares acquired	Status
Before 01.04.13	**All shares acquired i.e. 80%**	**Pre-acquisition**
01.04.13 to 31.08.13	**Shares acquired on 31.08.12 i.e. 30%**	**Pre-acquisition**
01.04.13 to 31.08.13	**Shares acquired before 31.08.12 i.e. 40%**	**Post acquisition**
After 31.08.13	**All shares acquired i.e. 80%**	**Post acquisition**

Holding Status:

Holding Company = 80%

Minority Interest = 20%

Date of Consolidation = 31.03.2014

Analysis of Profit & Loss Account of Green Ltd.

P&L balance on 31.03.2014	₹ 30,000
Less: Proposed Dividend for	
FY 2013-14 (₹ 1,00,000×10)**(Note 1)**	(₹10,000)
Correct Profit	**₹ 20,000**

Balance as on 01.04.2013

Balance as on 31.03.2014	₹30,000
Less: Net Profit during 2013-14	(₹9,000)
Less: 2013-14 Dividend	(₹1,000)
Capital Profit	**₹20,000**

Profit from 01.04.13 to 31.03.14

Profit during 2013-14	**₹9,000**
Less: Dividend for 2013-14	**(₹9,000)**
Revenue Profit	**NIL**

Note :

1. Dividend declared and paid by Green Ltd. is ₹10,000 (₹1,00,000 × 10%).

Dividend for 2013 – 14

Dividend for 2013-14 **₹10,000**

Out of Profit as at 01.04.2013 ₹1,000 **Out of Profit for FY 13-14 ₹9,000**

01.04.13 to 31.08.13 (5 Months) ₹3,750

01.09.13 to 31.03.14 (7 Months) ₹5,250

Consolidation of Balances

Particulars	Total ₹	Minority Interest ₹	Pre-Acquisition ₹	Post Acquisition
Green Ltd. (Holding 80%, Minority 20%)				**P&L A/c** ₹
Equity Capital	1,00,000	20,000	80,000	
Profit and Loss A/c	20,000	4,000	16,000	
Proposed Dividend	10,000	2,000	1,925 (Note 2)	6,075 (Note 3)
Minority Interest		26,000		
Total [Cr.]			97,925	
Cost of Investment [Dr.]			(99,000)	
Parent's Balance				10,000
For consolidated Balance Sheet			**1,075 Goodwill**	**16,075**

Note:

2. **Pre-acquisition : [80 % × ₹1,000 = ₹800] + [30% × ₹3,750] = ₹1,925.**
3. **Post acquisition : [50% × 3,750 = ₹1,875] + [80% × ₹5,250] = ₹6,075.**