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# Table of Contents

**Article....................................3**

Income-tax implications of issues of shares at a discount

**Notifications & Circulars..........6**

**Ratio Decidendi.........................9**

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# Article

## Income-tax implications of issues of shares at a discount

By S. Sriram and Dinesh Kukreja

The article in this issue of Direct Tax Amicus examines as to whether in case of fresh issuance or allotment of shares, be it Equity Shares or Preference Shares, Section 56(2)(x) of the Income Tax Act, 1961 would apply in the hands of the person to whom such shares are issued/allotted, if the shares are issued for consideration less than the Fair Market Value. Answering the question in negative, the authors note that firstly when the shares are allotted to the shareholders, such allotment would not amount to receipt of property 'from another person'. Secondly, this section is an anti-abuse provision while there is no abuse of the provisions of law, and thirdly, no tax can be levied on the shareholders for exercising their option under the contract. The authors also note that the issue, though having significant commercial implication, has not been subject to much judicial interpretation.

# Income-tax implications of issues of shares at a discount

The issue of shares by a company and its subscription by a shareholder is ordinarily on capital account, from the perspective of the company as well as the shareholder. No income can arise on issuance of shares by a company.

This principle was relied upon by a few denigrates to launder ill-gotten monies into formal commerce. To avoid this, the Legislature sought to treat monies received by a company on issuance of its shares, as resulting in income in the hands of the company.

Separately, tax on gift received was abolished in 1998. The tax was partly reintroduced by the Finance Act, 2004 in clause (v) of Section 56(2) of the Income Tax Act, 1961. This section sought to tax receipt of money by an individual or Hindu undivided family, without consideration. The object of the new section was stated to curb bogus capital-building and money laundering. By Finance Act, 2009, the ambit of taxation was expanded from just receipt of money to receipt of any property (including shares). The provision was modified from time to time and Legislated as Section 56(2)(x) by the Finance Act, 2017 with effect from 1 April 2017. The said section applies when any person receives, in any previous year, any property, either without consideration or for inadequate consideration, provided that (i) if without consideration, the Fair Market Value ('**FMV**') of such property is more than INR 50,000; and (ii) if with inadequate consideration, the difference between the FMV and actual consideration is more than INR 50,000. In such a scenario, the entire amount of FMV, if without consideration, and the entire differential amount (FMV Minus consideration paid) would be added to the income of the recipient of the property under Section 56(2)(x). The phrase 'fair market value' has been defined to mean the value as determined in accordance with Rule 11U and Rule 11UA of the Income-tax Rules, 1962 ('**IT Rules**').

'Person' includes all the types as provided under the Act, be it individual, company, firm, etc. 'Property' amongst other things, includes 'shares and securities', which form part of the Capital Asset of the recipient.

In this article, we will examine as to whether, in case of fresh issuance or allotment of shares, be it Equity Shares or Preference Shares, Section 56(2)(x) would apply in the hands of the person to whom such shares are issued/allotted if the shares are issued for consideration less than the FMV.

As stated above, the wordings of 56(2)(x) of the IT Act are very broad and they create a deeming fiction whereby if any person receives any property from any other person, for a consideration less than fair market value of the property, shall be deemed to have taxable income from the transaction. The deeming fiction created is a departure from the common understanding of the meaning of the word 'income'. Hence, for any reason, if the transaction does not fall within the strict wordings of the deeming fiction, the fiction would not be attracted.

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Rule 11U, read with Rule 11UA of the IT Rules provides for determination of fair market value for various situations and purposes.

In our view, Section 56(2)(x) would not be attracted in the hands of the person to whom such shares are issued/allotted if the shares are issued for consideration less than the FMV due to following reasons.

*Firstly*, Section 56(2)(x) of the IT Act brings to tax, receipt of property by any person 'from any other person'. Therefore, to fall within the ambit of taxation under this section, the property should be 'received from any person'. A property can be received from any person, only if the other person from whom the property is received, holds the property before conveying it further. It is a well-settled principle that, in case of issue of shares, the shares come into existence for the first time only when they are allotted to the shareholders. An issue of shares is the creation of the property for the first time. When the shares are allotted to the shareholders, such allotment would not amount to receipt of property 'from another person'.

*Secondly*, the Section is an anti-abuse provision, inserted after abolition of Gift Tax Act, was introduced to prevent laundering of unaccounted monies. The anti-abuse provision therefore will not apply to genuine issue of shares to shareholders. Thus, if due to justifiable commercial reason, the issue of shares is done at a price less than fair market value of those shares, there is no abuse of the provisions of law, and hence the section 56(2)(x) would clearly not apply.

*Thirdly*, no tax can be levied on the shareholders for exercising their option under the contract. When laws are made by representatives of people, it can be presumed that the law maker had in mind what the society considers honest, fair and reasonable. The Legislature could not have intended to tax a person for performing his obligations under a contract. By no degree of fairness and justice, where there is clearly no understatement of consideration in respect of the transfer and the transaction is perfectly honest and bona fide and, in fulfilment of a contractual obligation, the shareholders should be liable to pay tax on gains which have not accrued or arisen to them.

The issue discussed hereinabove, though having significant commercial implication, has not been subject to much judicial interpretation. While the Karnataka High Court has held that fresh issue of shares would not be regarded as 'receipt' of property as contemplated in the Section, the Income-tax Tribunal has taken a contrary view. The order of the Tribunal is under challenge before the Bombay High Court. In any case, for the detailed reasons discussed in the earlier paragraphs, fresh issue of shares by a company, either under a right issue or preferential allotment, should not be subject to tax in the hands of the shareholder under Section 56(2)(x) of the Income Tax Act.

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# Notifications & Circulars

- Statement of Financial Transactions (SFT) for Depository Transactions – Changes notified to the format, procedure and guidelines for submission
- Statement of Financial Transactions (SFT) for Mutual Fund Transactions by Registrar and Share Transfer Agent – Changes notified to the format, procedure and guidelines for submission
- Disclosure of information under Section 138(1)(a)(ii) – Officer/ authority/ body notified

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# Notifications & Circulars

## Statement of Financial Transactions (SFT) for Depository Transactions – Changes notified to the format, procedure and guidelines for submission

The CBDT has, *vide* corrigendum dated 15 November 2023, notified certain changes to the format, procedure, and guidelines for submission of Statement of Financial Transactions (SFT) for Depository Transactions which were notified by the CBDT *vide* Notification No. 3 of 2021 dated 30 April 2021:

- The requirement for furnishing SFT by the depository institutions is amended to be on a *half-yearly basis* (from existing quarterly basis) with effect from 1 April 2023 with the due date falling on 31st October for the first half of the financial year and on 30th April for the remaining half of the financial year.
- The estimated sale consideration for the debit transaction which was determined based on the best possible available price of the asset with the depository is now to be determined on *Weighted Average Price* i.e., taking into account the actual value of the transactions executed.
- Similarly, the manner of determination of the cost of acquisition for the corresponding credit transaction has also been amended to be on *Weighted Average Price* basis. The estimated cost of acquisition in case of IPO credit, which was previously taken to be NIL, shall now be determined using the formula i.e., Number of shares allotted x Per unit price at which share is allotted. Consequent changes have also been made in the data fields 16, 17 and 18 of Annexure D to the Notification. Further, a new data field 24 has been added for flag indication as to whether the purchase of the security was before 1 February 2018 or after.
- Sr. No. 5 of Annexure A to the Notification provided for the minimum period of holding beyond which the asset was to be treated as a long-term capital asset. The same has been amended to prescribe that in case of Units of UTI, Units of Business Trust, Other Units and Other Listed Securities, where if not more than 35% of the depository's total proceeds are invested in the equity shares of domestic companies, (Specified Mutual Fund), the asset will always be classified as a short-term capital asset. The classification for one additional asset namely Market Linked Debenture has been prescribed to be short-term capital asset in all cases (applicable from 1 April 2024).

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## Statement of Financial Transactions (SFT) for Mutual Fund Transactions by Registrar and Share Transfer Agent – Changes notified to the format, procedure and guidelines for submission

The CBDT has, *vide* corrigendum dated 15 November 2023, notified certain changes to the format, procedure, and guidelines for submission of Statement of Financial Transactions (SFT) for Mutual Fund Transactions by Registrar and Share Transfer Agents (RTA) which were notified by the CBDT *vide* Notification No. 4 of 2021 dated 30 April 2021:

- The requirement for furnishing SFT by RTAs is amended to be on a *half-yearly basis* (from existing quarterly basis) with effect from 1 April 2023 with the due date falling on 31st October for the first half of the financial year and on 30th April for the remaining half of the financial year.
- Sr. No. 7 of Annexure A to the Notification provided for the minimum period of holding beyond which the asset was to be treated as a long-term capital asset. The same has been amended to prescribe that in case of Units of UTI and Other Units, where if not more than 35% of RTAs' total proceeds are invested in the equity shares of domestic companies (Specified Mutual Fund), the asset will always be classified as a short-term capital asset (applicable from 1 April 2023).

## Disclosure of information under Section 138(1)(a)(ii) – Officer/ authority/ body notified

Section 138 of the Income Tax Act provides for the disclosure of information, pertaining to the assessees, by the CBDT / any other income-tax authority specified by it to the notified officer / authority / body performing functions under any other law, to enable such notified officer / authority / body to perform their functions under the concerned law.

In this regard, the CBDT has, *vide* Notification No. 99 dated 20 November 2023, notified Deputy Director General (Tech Development Division), Unique Identification Authority of India (UIDAI), Government of India, as the officer / authority / body.

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# Ratio Decidendi

- Time-limit for completion of assessment u/s 153B not stands extended in case of invalid reference for exchange of information made under DTAA – ITAT Mumbai
- Section 2(24)(xviii), which brings subsidy received on capital account within the ambit of 'income', constitutionally valid – Bombay High Court
- Dispute Resolution Panel can issue directions under Section 144C(5) only in case of a pending assessment – Bombay High Court
- Notice under amended Section 148 for A.Y. 2013-14, pursuant to a search conducted in F.Y. 2022-23, is within the limitation period – Jharkhand High Court
- Explanations 6 and 7 to Section 9(1)(i), being clarificatory in relation to Explanation 5, are applicable retrospectively – Delhi High Court
- Foreign exchange fluctuation gains received in EEFC account are outside the ambit of 'profits derived from the export. . .' for deduction u/s 80HHC – Supreme Court

# Ratio Decidendi

## Time-limit for completion of assessment u/s 153B not stands extended in case of invalid reference for exchange of information made under DTAA

In this appeal, the issue under consideration was whether the reference made by the Revenue to Swiss authorities requesting for information under Article 26 of India-Switzerland Treaty pertaining to the assessee for the Assessment Year 2008-09 is valid, thereby providing an extension of one year to the Assessing Officer for completing the assessment under Explanation (ix) to Section 153B of the Act.

In this regard, the Hon'ble ITAT observed that an amendment was made to India-Switzerland Treaty *vide* Notification No. S.O. 2903 (E) dated 27 December 2011. Per the amendment, only information related to any financial year beginning on or after 1 April 2011 could be exchanged under Article 26 (Exchange of Information). Thus, the Hon'ble ITAT, relying on *Praveen Sawhney* v. *ACIT* [(2023) 224 TTJ 46 (ITAT Del)], held that the request for information pertaining to Assessment Year 2008-09 (financial year 2007-08) made by the Assessing Officer could not have been made under the revised Article 26 of the Treaty. Further that, in view of the invalid reference, the period of limitation could not be extended as claimed by the Revenue and therefore, the assessment was barred by limitation. [*Priti Milan Mehta* v. *DCIT* - Order dated 31 October 2023 in ITA No. 3177/Mum/2022, ITAT Mumbai]

## Section 2(24)(xviii), which brings subsidy received on capital account within the ambit of 'income', constitutionally valid

*Vide* this petition, the constitutional validity of sub-clause (xviii) to Section 2(24) of the Income Tax Act (inserted *vide* Finance Act, 2015 w.e.f. 1 April 2016), which expanded the scope of 'income' to include assistance (by whatever name called and of whatever nature) by the Government or any authority or body or agency in cash or kind, was challenged.

The Bombay High Court upheld the constitutional validity of the concerned sub-clause while it observed that the said sub-clause does not make any unreasonable classification so as to violate Article 14 of the Constitution and that the excessiveness of tax or diminution of earnings consequent to taxation does not constitute violation of the rights under Article 19(1)(g). The Court was also of the view that the sub-clause did not suffer from the vice of discrimination and that it does not constitute 'taking away' of a benefit, but rather represents a recalibration of fiscal advantages in line with broader economic and policy considerations.

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The Hon'ble Court also held that the term 'income' is a term of elastic import and should be given its widest connotation in regard to the authority of the legislature to tax income under Entry 82 of List I in the Seventh Schedule to the Constitution.

The Court observed that before the amendment through Finance Act, 2015, the taxability of the subsidies/ assistance was determined by applying the 'purpose test' as laid down and followed in various judicial precedents. However, it is permissible for a competent legislature to overcome the effect of a decision of a Court by amending the relevant provisions of the statute, thus making all subsidies taxable unless they fall under an exclusionary category. [*Serum Institute of India Private Limited* v. *Union of India* – Judgment dated 4 December 2023 in Writ Petition No. 3735 of 2021, Bombay High Court]

## Dispute Resolution Panel can issue directions under Section 144C(5) only in case of a pending assessment

In the case, a draft assessment order was passed by the Assessing Officer for Assessment Year 2015-16. However, the Assessing Officer passed the final assessment order without waiting for the mandatory period of 30 days provided under Section 144C(2) of the Income Tax Act, confirming the draft assessment order. Between these two orders, the Assessee, being unaware of the final assessment order, filed its objections against the draft assessment order before the Dispute Resolution Panel (DRP). After having received a copy of the final assessment order, the Petitioner filed an appeal against the final assessment order before the Commissioner (Appeals) and also informed the DRP that it has no locus to proceed with the objections filed. Nonetheless, DRP issued its directions pertaining to the objections filed by the assessee and basis the same, the Assessing Officer passed another final assessment order.

The issue before the Bombay High Court was whether the directions issued by the DRP, and the consequent final assessment order were valid in the eyes of law.

The Hon'ble Court held that Section 144C(5) uses such phraseology that presupposes the existence of a pending assessment, wherein the DRP is to issue its directions in case of objections filed by an assessee. Therefore, where the final assessment order has already been passed (even if invalid), there is no pending assessment. Thus, the directions of the DRP issued subsequent to such invalid order and the consequent final assessment order, are invalid. [*Undercarriage and Tractor Parts (P.) Ltd.* v. *DRP* – Judgment dated 12 September 2023 in Writ Petition No. 2387 of 2020, Bombay High Court]

## Notice under amended Section 148 for A.Y. 2013-14, pursuant to a search conducted in F.Y. 2022-23, is within the limitation period

In this petition, the issue under consideration was whether the notice issued to the assessee, pursuant to a search in financial year 2022-23, under the amended Section 148 of the Income Tax

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Act for the Assessment Year 2013-14 is barred by limitation in view of the first proviso to the amended Section 149(1).

The Jharkhand High Court noted that after the amendment brought about by the Finance Act, 2021, any notice for assessment after 1 April 2021, which were to be issued under the unamended Section 153A/153C of the Act, are now to be issued under the amended Section 148 of the Act. However, by virtue of the first proviso to the amended Section 149(1), no notice under amended Section 148 can be issued at any time for an assessment year prior to the Assessment Year 2022-23, if a notice under unamended Section 153A/153C could not have been issued at that time on account of being beyond the time limit specified under the provisions of the unamended Section 153A/153C.

The Hon'ble Court also noted that Explanation 1 of Section 153A explains the expression of 'relevant assessment year' to mean an assessment year preceding the assessment year relevant to the previous year in which search is conducted or requisition is made which falls beyond six assessment years but not later than 10 assessment year from the end of assessment year relevant to previous year in which search is conducted or requisition is made. Thus, the Hon'ble Court held that since, in the instant case, the search was conducted in the financial year 2022-23 (Assessment Year 2023-24), the Assessing Officer was correct in issuing notice under the amended Section 148 for the Assessment Year 2013-14 as the limitation period of 10 years had not expired and therefore, the first proviso to Section 149(1) shall not be applicable. [*Devika Construction and Developers Private Limited* v. *PCCIT* – Judgement dated 28 November 2023 in W.P.(T) No. 2650 of 2023, Jharkhand High Court]

## Explanations 6 and 7 to Section 9(1)(i), being clarificatory in relation to Explanation 5, are applicable retrospectively

In this appeal, the issue under consideration was whether Explanations 6 and 7 to Section 9(1)(i) of the Income Tax Act, which were inserted *vide* Finance Act, 2015, will have retrospective effect.

Explanation 5 was introduced by Finance Act, 2012 (with effect from 1 April 1962), to provide a legal fiction by imputing situs to the share/ interest transferred outside the country by correlating it with the underlying assets in India. *Via* Explanation 6, it was clarified as to what would be deemed as an acquisition of assets of substantial value located in India upon the transfer of shares and interest in a company or entity registered or incorporated outside India. Furthermore, *via* Explanation 7, a *de minimis* clause was introduced which, in effect, excluded transactions where neither the transfer of shares or interest exceeded 5% of the total voting power or total share capital or total interest of the company whose share or interest was being transferred, nor did the transferor have the right of management or control *qua* such company in the 12 months preceding the date of transfer.

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Upon perusal of Explanations 5, 6 and 7 and the legislative history thereto, the Delhi High Court observed that Explanations 4 and 5 presented difficulties wherein the expressions 'share and interest' and 'substantially' used were vague, resulting in undue hardship for assessees. Thus, the legislature took a curative step regarding the vague expressions used in Explanation 5 by inserting Explanations 6 and 7 *vide* subsequent amendment by Finance Act, 2015.

The Hon'ble Court, thus, relying on the observations made in *CIT* v. *Alom Extrusions Ltd.* [(2010) 1 SCC 489] and *CIT* v. *Gold Coin Health Food Pvt Ltd.* [(2008) 9 SCC 622], held that although Explanations 6 and 7 were indicated in Finance Act, 2015 to take effect from 1 April 2016, they will be applicable retrospectively, having regard to the legislative history which led to their insertion in Section 9(1)(i). [*CIT* v. *Augustus Capital Pte. Ltd.* – Judgement dated 30 November 2023 in ITA No. 405 of 2022, Delhi High Court]

## Foreign exchange fluctuation gains received in EEFC account are outside the ambit of 'profits derived from the export. . .' for deduction u/s 80HHC

The assessee, a 100% Export-Oriented Unit, received foreign currency remittances. Instead of converting the exchange immediately to Indian currency, the assessee credited a percentage of the said foreign exchange to its Exchange Earners Foreign Currency ('**EEFC**') account. Subsequently, the appellant received a gain from the amount credited to the EEFC account due to an upward revision in the exchange rate at the end of the financial year. The assessee claimed this gain as a deduction under Section 80HHC of the Income Tax Act.

The Supreme Court, after perusing the guidelines issued for the EEFC account, observed that opening and maintaining an EEFC account is not a mandatory requirement for export business or earning profits in the business of export outside India. The concerned facts were distinguished by the Hon'ble Court from that in *Topman Exports* [2012 (3) SCC 593], in as much as there was no statutory requirement on the assessee to avail the facilities of an EEFC account in the present facts.

Further, referring to a catena of cases which dealt with the construction of the expression 'derived from', the Hon'ble Court held that the deduction under Section 80HHC is restricted only to profits of the business of export of goods and merchandise outside India by the assessee i.e., the profits which have direct and immediate nexus with export of goods/ merchandise. That, including other income as an eligible deduction would be counter-productive to the scope, purpose, and object of Section 80HHC. Therefore, the Court held that gain from foreign exchange fluctuations from the EEFC account is independent of export earnings and does not fall within the meaning of 'derived from' the export of garments by the assessee. [*Shah Originals* v. *CIT* – Judgement dated 21 November 2023 in Civil Appeal No. 2664 of 2011 a/w Civil Appeal No. 2665 of 2011, Supreme Court]

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