



## MCA notifies provisions relating to restriction on layers of subsidiaries under the Companies Act, 2013

3 October 2017

### First Notes on

Financial reporting

### Corporate law updates

Regulatory and other information

Disclosures

### Sector

#### All

Banking and insurance

Information, communication, entertainment

Consumer and industrial markets

Infrastructure and government

### Relevant to

#### All

Audit committee

CFO

Others

### Transition

#### Immediately

Within the next 3 months

Post 3 months but within 6 months

Post 6 months

Forthcoming requirement

### Background

#### Subsidiary – current requirements of the Companies Act, 2013

Section 2(87) of the Companies Act, 2013 (2013 Act) defines the terms ‘subsidiary’ or a ‘subsidiary company’ in relation to any other company (i.e. the holding company). It also contains a proviso which provides that specified class or classes of holding companies should not have more than a prescribed number of layers<sup>1</sup> of subsidiaries. This proviso was not made effective till now.

#### Investment company – current requirements of the 2013 Act

Section 186(1) of the 2013 Act provides that a company is not allowed to make investment through more than two layers of investment companies. However, the restriction of two layers of investment companies is not applicable in the following cases:

- A company acquires any other company incorporated in a country outside India if such other company has investment subsidiaries beyond two layers as per the laws of such country
- A subsidiary company having any investment subsidiary for the purposes of meeting the requirements under any law or under any rule or regulation framed under any law for the time being in force.

As per the explanation to Section 186(1), an investment company means a company whose principal business is the acquisition of shares, debentures or other securities.

These provisions (proviso to Section 2(87) and Section 186(1)) are aimed at monitoring the misuse of multiple layers of subsidiaries for diversion of funds/siphoning off funds and to ensure minority investor protection.

#### Recommendations of the Companies Law Committee and the Companies (Amendment) Bill, 2016

The Companies Law Committee (CLC) in its report issued in February 2016 proposed to remove the restriction on layers of subsidiaries on the ground that notification of these provisions would have a substantial bearing on the functioning, structuring and the ability of companies to raise funds. Also according to the CLC, sufficient safeguards have been built into the oversight mechanism of the Securities and Exchange Board of India (SEBI) and the stock exchanges with respect to investment companies. In line with the recommendations made by the CLC, the Companies (Amendment) Bill, 2016 also proposed to omit such restrictions.

Recently, the Ministry of Corporate Affairs (MCA) pointed out that it has been receiving

<sup>1</sup>Layer in relation to a holding company means its subsidiary or subsidiaries.

reports that certain companies may create shell companies for diversion of funds or money laundering. Therefore, MCA decided to operationalise the provisions relating to the restriction on number of layers for holding companies (Section 2(87)) and retain the requirements of Section 186(1) regarding the number of layers of investment companies. Accordingly, MCA issued draft rules for public comments through a notice (no.3/3/2017-CL-I) dated 28 June 2017.

## New development

On 20 September 2017, MCA issued notifications with regard to the following:

- Application date of proviso to Section 2(87) of the 2013 Act with effect from 20 September 2017
- Issue of Companies (Restriction on number of layers) Rules, 2017 (Restriction on layers Rules).

## Overview of the notified provisions

- **Restriction on layers of subsidiaries by holding companies (proviso to Section 2(87)):** A holding company can create up to two layers of subsidiaries only. However, one layer which consists of one or more wholly-owned subsidiary or subsidiaries would not be taken into account for computing the number of layers.  
  
The restriction regarding layers of the companies would not affect a holding company from acquiring a subsidiary incorporated in a country outside India, if such subsidiary has subsidiaries as per the laws of such country.  
  
The proviso to Section 2(87) is applicable from 20 September 2017.
- **Restriction on layers of investment companies (Section 186(1)):** The requirement for making an investment through not more than two layers of investment companies would continue to apply. The Section currently allows a holding company to acquire a subsidiary incorporated in a country outside India, if such subsidiary has subsidiaries as per the laws of such country. However, an investment company being a subsidiary of a holding company (covered under the proviso to Section 2(87)), would also be counted for the purpose of layer requirements.
- **Exemption from restrictions:** The above mentioned restrictions under both 'proviso to Section 2(87) and Section 186(1)' would not be applicable to the following class of companies:
  - a) A banking company
  - b) A systemically important Non-Banking Financial Company (NBFC) registered with the Reserve Bank of India (RBI)
  - c) An insurance company
  - d) A government company.
- **Actions required by the holding companies:** All holding companies, other than exempted companies, that have layers of subsidiaries in excess of two on or before the commencement of the Restriction on layers Rules (i.e. on or before 20 September 2017) would be required to comply with the following requirements:
  - a) *Filing of return with the ROC:* A return in Form CRL-1 (format specified in the annexure to the Restriction on layers Rules) comprising details of the layers of subsidiaries is required to be filed with the Registrar of Companies (ROC) within a period of 150 days from the date of publication of these rules in the official gazette (i.e. 17 February 2018).
  - b) *No subsequent addition to the layer:* A holding company with layers of subsidiaries in excess of two should not add any additional layer of subsidiary subsequent to the date of commencement of Restriction on layers Rules (i.e. 20 September 2017).
  - c) *Reduction in the number of layers:* The Restriction on layers Rules do not require holding companies to reduce the number of layers if in excess of two.  
  
However, in case a holding company reduces one or more layers after the commencement of the Restriction on layers Rules (i.e. after 20 September 2017), then the number of layers should not be more than the number of layers it has post such reduction or two layers, whichever is more.  
  
For instance, a holding company with four layers of subsidiaries and it proposes to reduce one layer post commencement of the Restriction on layers Rules (i.e. after 20 September 2017), then such a company should have maximum three layers of subsidiaries (i.e. higher of three layers post reduction or two layers).
- **Penal provisions:** On contravention of any of the above mentioned provisions, every officer of the company who is in default would be punishable with a fine up to INR10,000 which could be extended to INR1,000 for every day after the first during which such contravention continues.

## Our comments

The notification of two layers of subsidiaries is likely to help MCA keep a vigil over the number of layers of subsidiaries of the parent entities. However, these requirements would be challenging for companies that plan to grow both organically and inorganically through multiple layers of companies. Further, these requirements are likely to cause inflexibility while companies organise their management structures. We hope that the government would put in place other measures to curb diversion of funds activities and the requirements limiting the number of layers of subsidiaries would be waived off in future.

As mentioned above, the Restriction on layers Rules is applicable prospectively from 20 September 2017 and does not require companies with more than two layers of subsidiaries to reduce the number of layers provided they file a return comprising details of their subsidiaries to the ROC. The companies are not allowed to make any addition to its existing layers if in excess of two. Additionally, the number of layers post reduction, if any, should not be more than the number of layers it has after such reduction or two, whichever is more.

There are certain areas which require additional consideration. These are as follows:

- **Section 2(87) restriction vs 186(1) restriction:** Proviso to Section 2(87) of the 2013 Act allows specified class of companies to have up to two layers of subsidiaries (excluding one or more wholly-owned subsidiary or subsidiaries) whereas, Section 186(1) provides that the company is not allowed to make investment through more than two layers of investment companies. Section 2(87) is a pervasive section and would apply to all classes of companies including investment companies (covered in Section 186(1)).

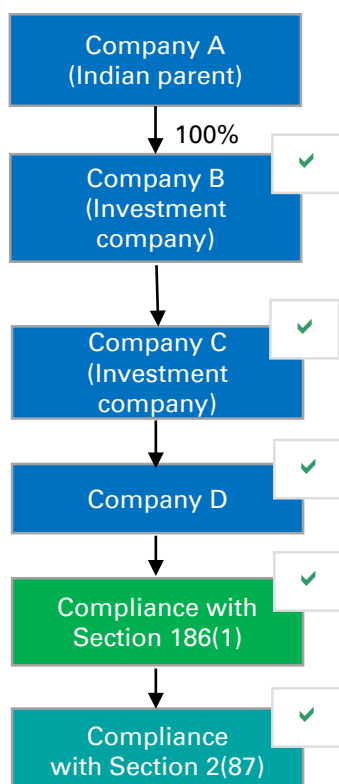
Currently, Section 186(1) allows a parent company to form two layers of investment companies while there was no restriction on the number of operating companies. However, with the application of proviso to Section 2(87), a company cannot form more than three layers (assuming one layer is a wholly-owned subsidiary) of companies for both operating and investment companies. If, however, first subsidiary is not a wholly-owned subsidiary then the parent company cannot have more than two layers of investment and operating companies. Therefore, proviso to Section 2(87) is likely to be more restrictive in nature. This can be illustrated with the help of following examples.

Examples:

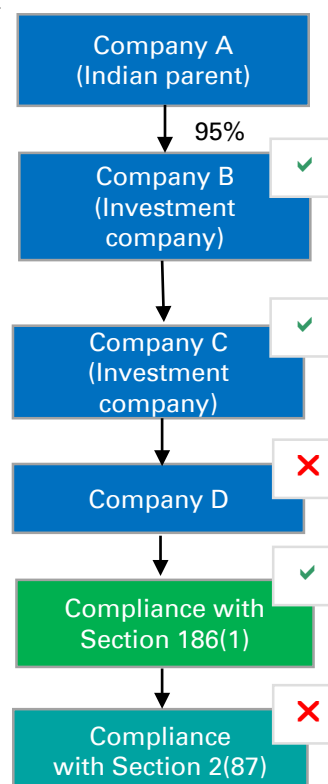
An investment company A proposes to form subsidiaries B, C and D where company B would be a wholly-owned subsidiary of A. B would be an investment company situated in Mauritius and C would be another investment company situated in Cypress while D would be an operating company in the United Kingdom. Now as per the notified provisions, company A could continue with all of them as its subsidiaries (as B is a wholly-owned subsidiary which is not to be counted for computation of two layers).

However, if company A proposes to own 95 per cent stake in company B, then in such a case, company A would not be able to create one operating company D as it can only create two layers of companies as per proviso to Section 2(87).

Situation 1



Situation 2



(Source: KPMG in India's analysis, 2017)

### Our comments (cont.)

- **Implication on Merger and Acquisition (M&A) transactions in India:** The Restriction on layers Rules specifically exempts a holding company from acquiring a subsidiary incorporated in a country outside India, if such subsidiary has subsidiaries as per the laws of such country. However, it does not contain any exemption for number of layers of subsidiaries for M&A transactions between Indian companies. There could be various situations that a group could be organised in various layers of subsidiaries and if it considers to acquire another group (with various layers of subsidiaries) then:
  - a) The purchaser would not be able to add a new subsidiary, it would be required to purchase through existing set of companies
  - b) The selling company would have to create a flatter structure in order to facilitate the acquisition.

This could pose significant challenge to M&A activity within the Indian companies including taxes and stamp duties on such transactions.
- **Regulatory requirement to form subsidiaries or special purpose entities or businesses formed as a conglomerate:** The provisions could also pose challenges to companies that are required to form various layers of subsidiaries or special purpose entities by certain regulations like infrastructure companies or real estate companies to claim certain concessions from the government. Additionally, large conglomerate business houses that operate through different verticals with step-up holding and step-down subsidiary companies would also need to consider the implications of the notified provisions.

### The bottom line

Companies should take appropriate actions and file Form CRL-1 (details of the layers of subsidiaries) by 17 February 2018.



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The website provides information and resources to help board and audit committee members, executives, management, stakeholders and government representatives gain insight and access to thought leadership publications that are based on the evolving global financial reporting framework.



## IASB issues an exposure draft to clarify how to distinguish accounting policies from accounting estimates

20 September 2017

On 12 September 2017, the IASB proposed amendments to IAS 8 by issuing an Exposure Draft ED/2017/5 Accounting Policies and Accounting Estimates (ED). The ED is expected to help entities distinguish accounting policies from accounting estimates.

Comments on the ED may be submitted to the IASB by 15 January 2018.

This issue of IFRS Notes provide an overview of the amendments proposed to IAS 8.

## Missed an issue of Accounting and Auditing Update or First Notes



### Issue no. 14/2017 – September 2017

The topics covered in this issue are:

- Non-controlling interests accounting under Ind AS
- Accounting of depreciation under the Companies Act, 2013
- Goodwill impairment - key considerations
- Educational material on Ind AS 16
- Regulatory updates.

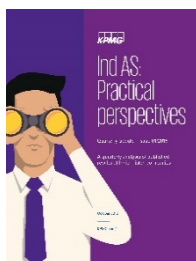


### SEBI mandates disclosures of defaults on repayment of loans from banks by listed entities

16 August 2017

The SEBI, through its circular dated 4 August 2017 has mandated listed entities who have defaulted in payment of interest/installment obligations on loans from banks and financial institutions, debt securities (including commercial paper), etc. to provide a disclosure of defaults to the stock exchanges within one working day from the date of the default in the manner prescribed in the circular. This circular is effective from 1 October 2017.

This issue of First Notes provides an overview of the new SEBI disclosure requirements for listed entities in case of default in repayment of loans taken from banks and financial institutions.



## Ind AS - Practical perspectives

KPMG in India's Ind AS - Practical perspectives through aims to put a finger on the pulse of India Inc's adoption of Ind AS and capture emerging trends and practices.

Our impact assessment is based on Nifty 50 companies which would be the first group of companies to report Ind AS results. The Nifty 50 companies have declared their financial results for the year ended 31 March 2017.

Out of the companies comprising Nifty 50 index, eight companies are banks, two are Non-Banking Financial Companies (NBFCs) and two companies follow a different date of transition to Ind AS. Therefore, our analysis would comprise the remaining 38 companies.

This can be accessed on KPMG in India website - '[Ind AS- Practical perspectives' webpage](#)

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