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TAX FLASH NEWS

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Share premium received from the foreign holding companies is on account of capital transaction and is not an income chargeable to tax in India

Background

Recently, the Mumbai Bench of the Income-tax Appellate Tribunal (the Tribunal) in the case of Finproject India (P.) Ltd.[1] (the taxpayer) held that share premium received by the taxpayer from its non-resident holding companies is on account capital transaction and it is not an income chargeable to tax in India. The Assessing Officer (AO) was not having any material/evidence on record to disregard the fair valuation of shares arrived at by the taxpayer. The taxpayer adopted the approved valuation method viz. Discounted Cash Flow (DCF) method which was certified by a qualified Chartered Accountant (CA). Accordingly, the Tribunal confirmed the Commissioner of Income-tax (Appeal) [CIT(A)] order deleting additions made by the AO under Section 56(1) and Section 68 of the Income-tax Act, 1961 (the Act).

Facts of the case

- The taxpayer is engaged in the business of manufacturing of soles for footwear. During the assessment proceedings of Assessment Year (AY) 2012-13, the AO observed that the taxpayer allotted equity share of face value of INR10 each at a premium of INR10 each to its non-resident holding companies.

- The AO made additions to the income of the taxpayer under Section 56(1) of the Act with respect to premium charged on allotment of share. Alternatively, in the opinion of the AO the share premium charged was in excess of the intrinsic valuation of shares. Therefore, additions were also made by the AO under Section 68 of the Act.

- The CIT(A) relied on the decision[2] and CBDT Instruction[3] and deleted the additions made by the AO.

Tax department's contentions

- The tax department distinguished the case of Vodafone India Services (P.) Ltd. relied upon by the taxpayer and the CIT(A) and contended that it is related to transfer pricing additions and not to additions made under Section 68 of the Act.

- The taxpayer is not only required to explain the 'source' of credit entry but also its 'nature' which as per AO, the taxpayer could not explain.

Taxpayer's contentions

- There were only two shareholders of the taxpayer namely Asian Compound Limited, Hong Kong and Finproject Asia Limited, Hong Kong, which are limited companies incorporated abroad and promoted the taxpayer.

- This is the second year of operation and company is in profit from the very first year itself and taxes were also paid for these first two years of operations.

- Share capital was raised by the taxpayer after obtaining RBI approvals and valuations have been done following DCF method which is an approved method for valuation of shares notified by RBI.

[1] DCIT v. Finproject India (P.) Ltd. [2018] 93 taxmann.com 461 (Mum)

[2] Vodafone India Services (P.) Ltd. v. UOI [2014] 368 ITR 1 (Bom)

[3] CBDT Instruction No. 2/2015, dated 29 January 2015

- Shares cannot be issued by a closely held company whose shares are not listed on recognised stock exchanges below fair price determined under DCF method to foreign investors.

- The fair value of shares to be determined using DCF method is to be certified by CA or SEBI registered Category-1, Merchant Banker.

Tribunal's decision

- The CIT(A) deleted the additions towards share premium made under Section 56(1) of the Act. The tax department was not aggrieved by the said relief granted by the CIT(A) with respect to the deletion of additions made under Section 56(1) of the Act. However, it is aggrieved with respect to deletion of additions under Section 68 of the Act.

- It is evident from audited financial statements that neither the taxpayer incurred any loss during the first two years of its existence nor does it have any accumulated losses in its books of accounts as at 31 March 2011 as well as at 31 March 2012, as is alleged by AO in assessment order which is a perverse finding of fact arrived at by the AO that the taxpayer is making losses and has accumulated losses in its balance sheet and these finding of fact arrived by the AO needs to be discarded.

- The AO questioned and disputed the fair value arrived at by the taxpayer of the equity shares on these perverse finding of facts. The observations of the AO to discard fair value of shares adopted by the taxpayer are perverse finding of facts arrived at by the AO which cannot be relied upon to prejudice the taxpayer.

- On perusal of the audited financial statements, it is also revealed that the taxpayer only issued one class of shares viz. Equity shares and it never issued any preference shares till the end of the financial year 2011-12. It also transpires from the audited financial statements that the taxpayer's investments as on 31 March 2011 and 31 March 2012 were nil.

- The AO gave finding of fact that the taxpayer issued preference shares and made investment in volatile companies to discard valuation of shares arrived at by the taxpayer. This finding of fact was again perverse finding of facts which need to be discarded.

- Thus, errors had been made by the AO in recording perverse finding of facts not supported by the material/evidence on record to discredit fair valuation of shares arrived at by the taxpayer by adopting approved valuation method viz. DCF method which was certified by a qualified CA.

- The AO also erred in holding that there is a violation of Section 78 of the Companies Act, 1956 (the Companies Act) by holding that the taxpayer ought to have utilised the proceeds of share premium for certain specified purposes as is stipulated in the Section 78 of the Companies Act viz. paying up unissued shares of the company as bonus shares, writing off preliminary expenses, buy-back of shares, etc.

- The AO erred in not distinguishing what is meant by utilisation of the funds being proceeds of share premium raised for the specified approved purposes as per terms and condition of invitation to offer issued by the taxpayer for raising share capital.

- The taxpayer rightly utilised the proceeds of funds raised towards share premium for setting up manufacturing unit of soles for footwear and business purposes as per terms and conditions of the invitation to offer. Further the taxpayer had transferred share premium raised to 'Share Premium Account' under the head 'Reserves and Surplus' in books of accounts as is mandated under Section 78 of the Companies Act.

- The taxpayer while issuing shares to non-resident investors creates a foreign obligation for India in favour of third country and as per Reserve Bank of India (RBI)/Foreign Exchange Management Act (FEMA) requirements, the taxpayers are required to issue shares using valuation methods which are approved method (DCF is approved method of valuation).

- Thus, the taxpayer was on the right side of the law by issuing equity shares at a value of INR20 per equity shares so far as FEMA/RBI compliances are concerned. RBI has also accepted the said fair price of shares supported by CA Certificate using DCF method.

- Section 56(2)(viib) read with Section 2(24)(xvi) of the Act were introduced in statute by Finance Act, 2012 with effect from 1 April 2013 and the said sections are relevant for issuance of shares to residents. In the instant case, undisputedly equity shares were issued by the taxpayer to non-resident. Thus said Section 56(2)(viib) of the Act are not made applicable to the shares issued to non-residents mainly to encourage foreign investments.

- The tax department erred in making contentions that the case of Vodafone India Services (P.) Ltd. is relevant for Transfer Pricing (TP) proceedings. While TP provisions as are contained in Chapter X of the Act are machinery provisions, there has to be firstly an income chargeable to tax and then only machinery provisions can be applied. The issue of shares at share premium by taxpayer to non-resident holding entities was held to be on account of capital transaction which were not found to be having character of income chargeable to tax. CBDT has also accepted this position vide Instruction No. 2/2015.

- The Tribunal confirmed the CIT(A)' order keeping in view factual matrix of the case and hence no addition is warranted towards share premium received by the taxpayer from its holding companies as the said share premium was on account capital transaction and was not an income within charging sections of the Act.

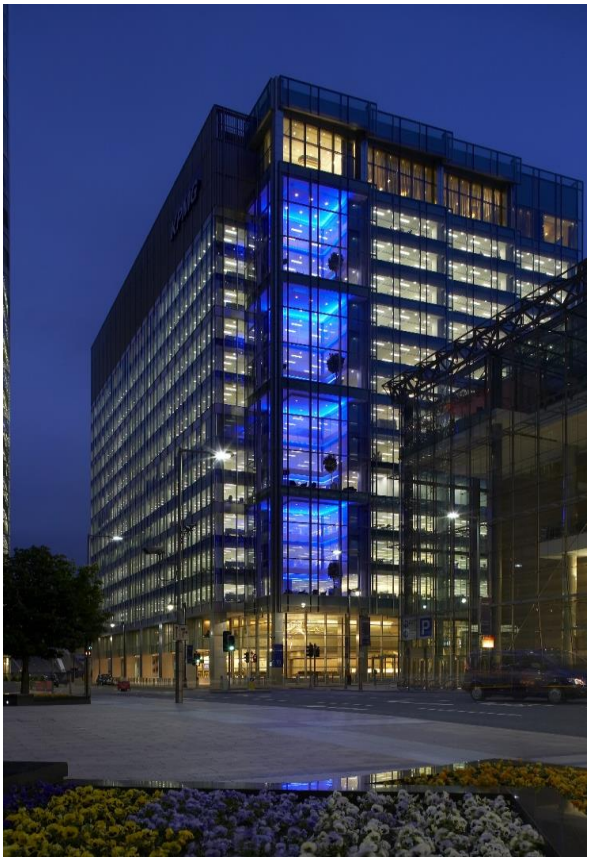
Our comments

The issue with respect to taxability of share premium on issue of shares by a closely held company has been a matter of debate before the Courts/Tribunal.

The Mumbai Tribunal in the case of Credit Suisse Business Analysis[4] reversed the CIT(A)'s order for AY 2010-11 and held that 'share premium' received by the taxpayer is not taxable as income from other sources. The tax department had taxed share premium as a trading receipt on the ground that taxpayer had used share premium collected for its day to day business activities which amounted to violation of Section 78 of Companies Act. The tax department was not able to substantiate that share premium was utilised for day to day business and considering that opening and closing balance of share premium account remained unchanged. The Tribunal observed that the receipt was on account of capital transaction.

The Bangalore Tribunal in the case of Cornerstone Property Investments Pvt. Ltd.[5] held that the taxpayer received high share premium as a conduit to route the funds involved as a 'layering' process. Therefore, share-premium is taxable under Section 68 of the Act as unexplained cash credit. The Tribunal observed that there was absence of proper valuation report to justify high premium, relatively weak financials compared to high valuation, issue of shares to directors at par, discrepancies/abnormal features which indicate that share issue was 'made up' to camouflage the real purpose/intention of routing money.

In the instant case, the Mumbai Tribunal held that the receipt of share premium is on capital account. The same is not chargeable to tax under the Act. Accordingly, additions made under Section 56 and Section 68 of the Act are deleted.



[4] Credit Suisse Business Analysis v. ACIT (ITA No. 993/Mum/2015)
[5] Cornerstone Property Investments Pvt. Ltd v. ITO (I.T. A. No.665/Bang/2017)

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