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Tax Flash News

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Consideration received in excess of FMV on issuance of FCCDs not taxable, as FCCDs are not akin to shares

Executive summary

In the case of *PH4 Food and Beverages*[1] ('taxpayer'), the Bangalore Bench of the Income-tax Appellate Tribunal ('the Tribunal') examined whether the fully and compulsorily convertible debentures ('FCCDs') could be regarded as shares, and accordingly, whether the consideration received on their issuance (i.e., issue price of FCCDs) in excess of their fair market value ('FMV') could be treated as income from other sources for the issuing company under section 56(2)(viib) of the Income-tax Act, 1961 ('the 1961 Act').

The Tribunal held that section 56(2)(viib) was applicable only where consideration was received for the issue of shares and did not extend to convertible debentures in the absence of an express deeming provision in the 1961 Act. The issuance of FCCDs and their subsequent conversion were separate events, and their compulsory conversion at a future date did not alter their character in the year of issuance.

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[1] *PH4 Food and Beverages Private Limited* v. *DCIT* (ITA 242/Bang/2026)

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Facts of the case

During FY 2020-21, the taxpayer, an Indian private limited company, issued equity shares and FCCDs. The FCCDs were issued at a significantly higher price than the equity shares. The FCCDs were valued by an independent registered valuer using the Discounted Cash Flow ('DCF') method, whereas the valuation of equity shares was based on DCF workings prepared internally in connection with an earlier rights issue.

The Revenue considered the significant disparity between the two valuations, undertaken within a span of approximately six months, to be unjustified. Relying on the RBI guidelines and the FDI policy, the Revenue held that FCCDs were quasi-equity instruments akin to equity shares and sought to tax the excess consideration received on issuance of FCCDs as income from other sources under section 56(2)(viib) of the 1961 Act.

The taxpayer explained that the disparity in valuations arose from differing commercial circumstances and funding objectives. During the COVID-19 period, equity shares were issued to raise limited emergency funds and subsidiaries were valued at book value, whereas FCCDs were issued for substantial funding requirements, warranting a DCF valuation based on expected future cash flows from subsidiaries and business expansion.

Relevant provisions

Section 56(2)(viib), as applicable in the relevant year,[2] provided that where a closely held company received, from a resident person, any consideration for issue of shares exceeding the face value of such shares, then the aggregate consideration received for such shares as exceeding the FMV of the shares was taxable as income from other sources.

Tribunal's decision

The Bangalore Bench of the Tribunal ruled in favour of the taxpayer and held that the issuance of FCCDs could not be regarded as an issue of shares for the purposes of section 56(2)(viib). Having concluded so, the Tribunal did not adjudicate on the correctness of the respective valuations of the equity shares and FCCDs.

[2] Section 56(2)(viib) is not applicable on or after 1 April 2025

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Key observations of the Tribunal included:

The issue of shares is the basic jurisdictional condition for invoking the provisions of section 56(2)(viib). The section does not use the expression “securities”, “debentures”, “convertible securities” or “instruments convertible into shares”.

There is no deeming provision in section 56(2)(viib) treating FCCDs as shares before their conversion. Accepting the Revenue’s interpretation would require reading ‘FCCDs or other securities convertible into shares’ into section 56(2)(viib), which is impermissible. A deeming provision that seeks to tax a capital receipt must be confined to the scope expressly prescribed by the legislature and cannot be extended to transactions that fall outside the plain language of the statute.

Further, Rule 11UA(2) provides a valuation mechanism only for shares.

The issue of FCCDs and their subsequent conversion into equity shares are two separate events. On the date of receipt of consideration against the FCCDs, the company issued debentures carrying contractual terms, and not equity shares. The interest payable on the FCCDs was allowed as expenditure by the Revenue.

.The fact that FCCDs would compulsorily convert into equity at a future date did not transform them into shares for the purposes of section 56(2)(viib).

Relied on its earlier decision in the case of *Rankin Infrastructure*,[3] wherein it was held that section 56(2)(viib) requires the receipt of consideration and issue of shares to occur in the manner contemplated by the provision and that conversion of debentures into shares without fresh receipt of consideration could not by itself attract section 56(2)(viib). This reasoning reinforces the distinction between the original issue of a convertible debenture and the subsequent issue of shares upon the conversion.

Rejected the reliance placed by the Revenue on the Supreme Court’s decision in *IFCI Ltd*.[4] The said decision was rendered in the context of insolvency proceedings under the Insolvency and Bankruptcy Code, 2016 (‘the IBC’) and dealt with the question of whether compulsorily convertible debentures (‘CCDs’) were to be treated as ‘debt’ or ‘equity’ where such CCDs had already matured and were converted into equity shares. The Supreme Court observed that whether CCDs constitute debt or equity depends on their maturity status and the facts of each case. The Tribunal distinguished this decision as the FCCDs in

[3] *DCIT* v. *Rankin Infrastructure (P.) Ltd*. [2022] 142 taxmann.com 37 (Mumbai Tribunal)

[4] *IFCI Ltd.* v. *Sutanu Sinha* [2023] 156 taxmann.com 681 (SC)

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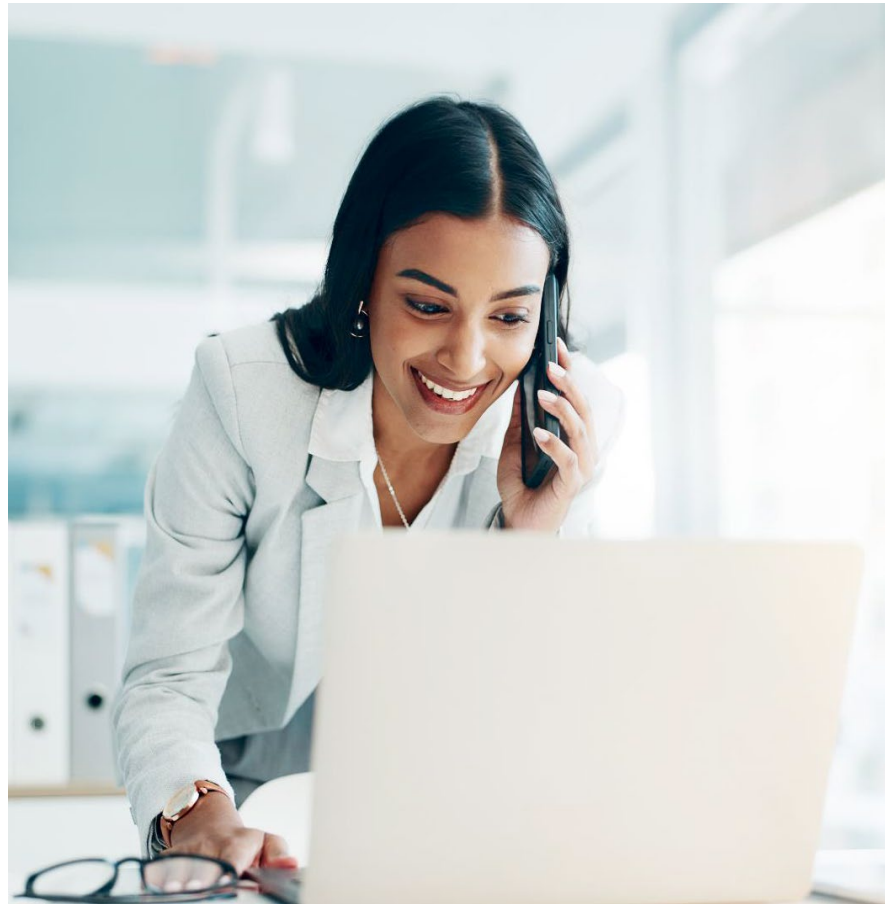
the instant case had not matured during the relevant year and held that the factual stage at which the character of FCCDs was examined in the case of *IFCI Ltd*. was materially different.

The character assigned to a convertible instrument under the RBI/ FDI framework or under the IBC could not, in the absence of an express provision in the 1961 Act, enlarge the scope of the charging provision under section 56(2)(viib).

Our comments

The ruling reinforces that the taxability of a financial instrument must be determined by its legal character and the express language of the charging provision. A compulsorily convertible instrument does not assume the character of equity merely because conversion is certain at a future date.



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