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Tax Flash News

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Option money received for grant of right of first refusal to other shareholder, being advance against sale of shares, is a capital receipt

Executive summary

The Right of First Refusal (ROFR) clauses are commonly found in Joint Venture (JV) and shareholder agreements, with the objective to protect investments and restrict entry of new shareholders. Typically, a ROFR provides that a shareholder may undertake transfer of shares to a third-party only after another shareholder (holding ROFR) first refuses to buy such shares. In lieu of granting ROFR, the former shareholder is paid option money by the latter (ROFR holder). The taxability of such receipts – whether a capital or revenue receipt – is often a matter of litigation in India.

In the case of *Dabur Invest Corp.*[1], the Delhi Bench of Income Tax Appellate Tribunal (Tribunal) held that the option money received by the taxpayer for granting ROFR to a JV partner constitutes a capital receipt, as it represents advance received by the taxpayer against a future transfer of shares to the JV partner.

Further, such option money is required to be adjusted when computing capital gains at the time of actual share transfer by the taxpayer to the JV partner.

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[1] *ACIT* v. *Dabur Invest Corp.* (ITA No. 2453/Del/2022 & ITA No. 2454/Del/2022)*; Dabur Invest Corp.* v. *JCIT* (ITA No. 2447/Del/2022)

Facts of the case

The taxpayer entered into a JV Agreement with a UK-based company (JV partner) for promoting insurance business in India. The taxpayer held 74 percent equity shares in the JV company, while the remaining 26 percent was held by the JV partner, being the maximum permissible foreign direct investment (FDI) limit in the insurance sector at that time.

As per the JV Agreement, the taxpayer was permitted to sell the shares in the JV company to a third-party only after the JV partner refused to buy the shares.

In this regard, the taxpayer received annual option price from the JV partner, as per the rates prescribed in the JV Agreement.

The JV Agreement also stipulated that the option price received by the taxpayer was to be appropriated at the time of transfer of shares to the JV partner[2].The amount of option price to be appropriated was to be determined based on the market value of shares so transferred. If the option price received by the taxpayer exceeded the prescribed formula in the JV Agreement, the excess option price would be refunded by the taxpayer.

In earlier years, the taxpayer received option money from the JV partner, which has been held to be a capital receipt (as in the nature of an advance received against the sale of shares) in the taxpayer's own case for those years[3].

During the year under consideration, the taxpayer transferred 23 percent of its shareholding in the JV company to the JV partner for a consideration determined by the Indian regulatory authority (Market Value).

The taxpayer computed taxable capital gains after making following adjustments –

(a) adding[4] the proportionate amount of option money received in earlier years to the Market Value, so as to arrive at the amount of sale consideration; and

(b) claiming deduction of capitalised amount of interest on funds borrowed to acquire the shares and professional charges.

The Revenue alleged that the option money received has no relation with the sale of shares but is revenue in nature and hence, taxable as business income. The Market Value received from the JV partner was also treated at par with option money and taxed as business income.

[2] If there is an increase in the permissible FDI limit on the shareholding of the foreign entity

[3] ITA No.482/2019 and 483/2019

[4] Only the option money retained by the taxpayer was added. A part of option money was refunded to JV partner which was not considered in the computation.

Revenue's contentions

Recurring nature of the payment of option price to the taxpayer indicated that it was revenue in nature and not a capital receipt.

The JV Agreement is merely a financial transaction wherein the JV partner guarantees a fixed annual return to the taxpayer in return for exclusive right to purchase shares by the former in the event of change of FDI rules - suggesting an investment-like income for the taxpayer. Further, the real owner of the shares has right to sell shares whereas in the instant case, the taxpayer has no right to sell its shares except to the JV partner.

Option price received by the taxpayer has been invested in income-earning securities and therefore, it cannot be considered as a capital receipt. There is no restriction on the taxpayer on the utilisation of option money or to put it in an escrow account.

Citing the Tribunal's decision in the case of *Mahindra Telecommunications*[5], the Revenue argued that the option price received by the taxpayer is a taxable income.

[5] *Mahindra Telecommunications Investment Private Limited* v. *ITO* [2016] 69 taxmann.com 431 (Mumbai Tribunal)

Deduction for interest on borrowed funds and professional expenses should be disallowed as these are revenue in nature and if not claimed in the return of income filed for the year, cannot be allowed as deduction[6].

Tribunal's Decision

The Delhi Bench of the Tribunal ruled in favour the taxpayer and held that option money received from the JV partner for grant of ROFR is a capital receipt. The Tribunal referred to its earlier decisions in taxpayer's own case, as elaborated below.

Option money constituted a liability, which the taxpayer may have to refund to the JV partner in certain circumstances. Whether the taxpayer retains or refunds the option money can be determined only at the time of transfer of shares by the taxpayer. In fact, a portion of option money was refunded by the taxpayer to the JV partner.

Though option price is received by the taxpayer on a regular basis and generates constant cash flow in the hands of the taxpayer, it cannot be said to be an income. The characterisation of a receipt as an income is determined based on the nature of receipt and not based on frequency or accounting treatment.

[6] *Goetze (India) Ltd*. v. *CIT* [2006] 284 ITR 323 (SC)

Rejecting the Revenue's argument that JV Agreement is merely a financial transaction, the Tribunal held that the JV Agreement is in the nature of a shareholders' agreement. The ROFR to buy the stake of other JV partner is common in case of closely held companies. The option price is a minimum exit value of the taxpayer's investment guaranteed by the JV partner, which is generally found in many of the private investments. The only difference in the instant case is that the taxpayer is periodically receiving the minimum guarantee over a period of time as advance against the sale of shares. But that does not make the advance sales consideration as revenue receipt.

Considering that the taxpayer is entitled to dividends over and above the option price, and the option price received in advance is required to be adjusted at the time of share transfer, such option price is not income from investment in shares but a capital receipt.

Rejecting the Revenue's argument relating to the utilisation of the option money, the Tribunal held that utilisation of the option money by the taxpayer cannot determine the character of the same as capital or revenue receipt.

The *Mahindra Telecommunications* case was distinguishable, as it dealt with the timing of income accrual, and not whether the receipt was capital or revenue in nature. In that case, as the option price was a fixed return (and not linked to market value), there was no uncertainty in realisation. On the contrary, in the instant case, the issue is whether option money is capital or revenue in nature. The option price is adjustable and linked to market value, and there are conditions for refund of option price in certain circumstances – in fact, a part of option money was refunded by the taxpayer to the JV partner.

In view of the above, the Tribunal held that option money received by the taxpayer is a capital receipt and such option money has to be taxed under the head 'capital gains' in the year of transfer of shares to the JV partner.

The Tribunal accepted the taxpayer's argument that interest paid on borrowed funds utilised for the acquisition of assets has to be capitalised from the date of acquisition till the date of sale of such assets[7]. Apart from reduction of the subscription price of the shares transferred by the taxpayer, the proportionate interest and other professional expenses as capitalised by the taxpayer towards the cost of shares should also be allowed as deduction.

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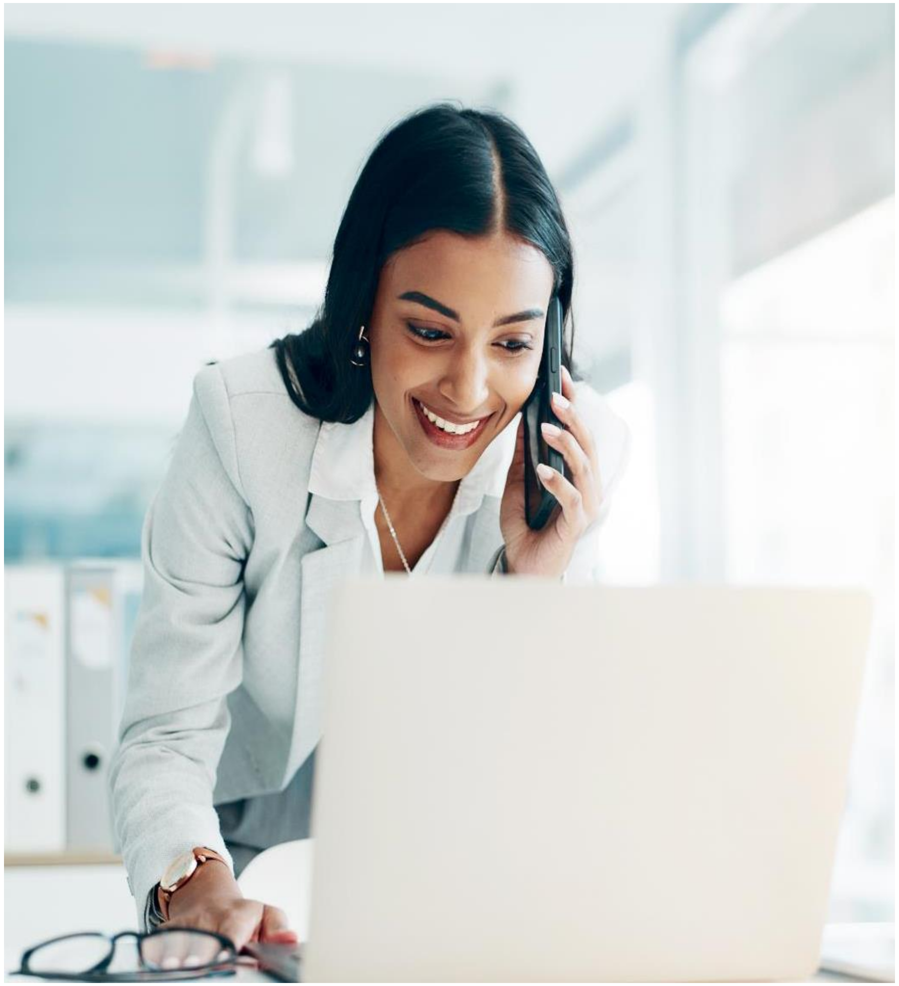
[7] *CIT* v. *Mithlesh Kumari* [1973] 92 ITR 9 (Delhi); *CIT* v. *Trishul Capital Limited* [2008] 215 CTR 96 (Madras); *CIT* v. *Shri Hari Ram Hotels Private Limited* [2010] 325 ITR 136 (Karnataka*); Zuari Investments Limited* v. *ITO* [2022] 215 TTJ 515 (Delhi Tribunal)

Our comments

The Tribunal has re-affirmed the established legal principle that the underlying purpose of a payment is a critical determinant of its classification. The recurrence of the payment, in isolation, does not determine whether it should be treated as capital or revenue in nature.



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