#KPMGjosh

TAX FLASH NEWS

12 July 2022

Section 56(2)(viib) is applicable to conversion of CCDs into equity shares

Section 56(2)(viib) of the Income-tax Act, 1961 (the Act) is applicable to a private company on receiving any consideration for issue of shares that exceeds the face value of such shares. The aggregate consideration received for such shares as exceeds the Fair Market Value (FMV) of the shares is be deemed to be the income of the concerned company chargeable under the head ‘Income from other Sources’.

Recently, the Kolkata Bench of the Income-tax Appellate Tribunal (the Tribunal) in the case of Milk Mantra Dairy Pvt. Ltd.[1] (the taxpayer) dealt with the applicability of Section 56(2)(viib) to the conversion of Compulsorily Convertible Debentures (CCDs) into equity shares. The Tribunal held that Section 56(2)(viib) is applicable on conversion of CCDs into equity shares undertaken during Assessment Year (AY) 2013-14[2]. On the valuation of FMV, the Tribunal observed that the tax department cannot disregard the Discounted Cash Flow (DCF) method of valuation adopted by the taxpayer and recompute the FMV using the Net Asset Value (NAV) method.

Facts of the case

- During AY 2011-12 and AY 2012-13, the taxpayer, a private limited company, entered into an agreement with its investors for issuance of CCDs. Such CCDs were subsequently converted into equity shares in AY 2013-14 i.e., the year under consideration.

- At the time of conversion of CCDs into equity shares, the taxpayer issued equity shares to various parties including VCFs, non-residents and other angel investors at a premium. The entire consideration was received by the taxpayer at the time of issuance of CCDs.

- The taxpayer contended that Section 56(2)(viib) does not apply since these provisions were not in existence when the money was received on issue of CCDs. The conversion price range was pre-determined which was agreed upon between the parties and it was prior to the insertion of Section 56(2)(viib).

- The AO observed that the equity shares were issued over and above the FMV and the provisions of Rule 11UA(2)(a) were applicable. The AO doubted the taxpayer’s valuation report and adopted NAV method for computing the FMV.

Tribunal’s decision

Applicability of Section 56(2)(viib) on the conversion of CCDs into equity shares

- The term ‘consideration’ used in Section 56(2)(viib) is a term of wider import when compared with words ‘amounts’ or ‘money’. Section 56(2)(viib) contains the words ‘receives any consideration’ which encompasses consideration in all forms and not limited to only receipt of money. In the present case, the taxpayer received consideration on the conversion of a debt security of CCDs as equity shares which subsequently forms part of the capital base of the taxpayer.

- Some of the “*considerations*” which the taxpayer “receives” on the conversion of its CCDs into equity shares are as under (not exhaustive):

  - ➢ The debt obligation on the taxpayer to repay is extinguished.

  - ➢ The charge created on the assets/properties of the taxpayer to secure the debt obligation is released.

---

[1] Milk Mantra Dairy Pvt. Ltd. v. DCIT (ITA No.413/Kol/2020) – Taxsutra.com

[2] Section 56(2)(viib) applicable to AY 2013-14 in the existing case

- The cost of servicing the debt obligation by paying periodic interest is mitigated.

- The capital based in the form of own fund gets widened to leverage on the capital/stock markets.

- The debt-equity ratio becomes favorable to various stakeholders of the taxpayer making it more investor attractive/lucrative.

- The risk of getting into the claim of insolvency resolution from the debt creditors in case of default in servicing their debt obligation is mitigated, so on and so forth…

- The conversion of CCDs into equity shares entails receipt of consideration by the taxpayer which is translated into the total issue price including share premium.

- Section 56(2)(viib) does apply in the present case which involves receipt of consideration by the taxpayer on conversion of CCDs into equity shares, more particularly when the law was in force during AY 2013-14 i.e. the year of conversion.

- The decisions[3] relied on by the taxpayer were distinguishable on facts of the present case. Those cases did not deal with the conversion of securities but receipt of share application money.

Valuation

- In Explanation (a)(ii) to Section 56(2)(viib), it is specifically provided that the valuation is to be substantiated to the satisfaction of the AO. However, there is no such provision specified in Explanation (a)(i) of Section 56(2)(viib) as opted for by the taxpayer for substantiating its valuation to the satisfaction of the AO. Hence, on the facts of the case, the AO was not empowered to disregard the DCF valuation as carried out by the valuer. The Tribunal disregarded the AO's action of rejecting such valuation report and adopting the NAV method.

- The DCF method is essentially based on projection (estimates) only and hence, this projection cannot be compared with the actual results.

- Rule 11UA(2) gives an option to the taxpayer to opt and adopt either of the two methods prescribed therein, i.e. the NAV method or the DCF method. The AO has no right to change the method of valuation adopted by the taxpayer who had opted for the DCF method. The Tribunal referred to the decision of the Bombay High Court in the case of Vodafone M-Pesa Ltd[4].

- Accordingly, the basis for valuation of equity shares in the present case has to be the DCF method opted by the taxpayer as prescribed under Rule 11UA(2)(b).

- The taxpayer had not supplied the MIS data which was given to the valuer for the purpose of valuation of shares and also the details on the assumptions so as to conclusively establish that the projections used for DCF valuation were prepared scientifically. Thus, the matter was remitted for the issue of valuation of shares to the AO for the limited purpose of verification to arrive at satisfaction on the scientific basis of valuation and rationality of assumptions adopted. The Tribunal referred to the decision of the Bangalore Tribunal in the case of Innoviti Payment Solutions Pvt. Ltd.[5]

Our comments

Since its insertion, applicability of section 56(2)(viib) in case of convertible instruments has been a debated one especially, considering that the issue of equity shares pursuant to conversion is basis the pre-determined/pre-agreed conditions.

The Tribunal while upholding the applicability of the section 56(2)(viib) on issue of equity shares pursuant to conversion of CCDs, observes that the term 'consideration' is of wide import and encompasses all forms not limited only to receipt of money. However, the Tribunal has not commented on the method of valuing such consideration.

---

[3] ACIT v. Diach Chemicals & Pigments Pvt. Ltd. (ITA No. 546/Kol/2017 for AY 2013-14, dated 19 June 2019) and India Today Online (P.) Ltd. v. ITO [2019] 176 ITD 45 (Del)

[4] Vodafone M-Pesa Ltd. v. DCIT [2018] 92 taxmann.com 73 (Bom)

[5] Innoviti Payment Solutions Pvt. Ltd. [2019] 175 ITD 10 (Bang)

KPMG in India addresses:

Ahmedabad
Commerce House V, 9th Floor,
902, Near Vodafone House, Corporate Road,
Prahlad Nagar,
Ahmedabad – 380 051.
Tel: +91 79 4040 2200

Bengaluru
Embassy Golf Links Business Park,
Pebble Beach, ‘B’ Block,
1st & 2nd Floor,
Off Intermediate Ring Road, Bengaluru – 560071
Tel: +91 80 6833 5000

Chandigarh
SCO 22-23 (1st Floor),
Sector 8C, Madhya Marg,
Chandigarh – 160 009.
Tel: +91 172 664 4000

Chennai
KRM Towers, Ground Floor,
1, 2 & 3 Floor, Harrington Road,
Chetpet, Chennai – 600 031.
Tel: +91 44 3914 5000

Gurugram
Building No.10, 8th Floor,
DLF Cyber City, Phase II,
Gurugram, Haryana – 122 002.
Tel: +91 124 307 4000

Hyderabad
Salarpuria Knowledge City,
6th Floor, Unit 3, Phase III,
Sy No. 83/1, Plot No 2, Serilingampally
Mandal,
Ranga Reddy District,
Hyderabad – 500 081.
Tel: +91 40 6111 6000

Jaipur
Regus Radiant Centre Pvt Ltd.,
Level 6, Jaipur Centre Mall,
B2 By pass Tonk Road,
Jaipur – 302 018.
Tel: +91 141 - 7103224

Kochi
Syama Business Centre,
3rd Floor, NH By Pass Road,
Vytilla, Kochi – 682 019.
Tel: +91 484 302 5600

Kolkata
Unit No. 604,
6th Floor, Tower – 1,
Godrej Waterside,
Sector – V, Salt Lake,
Kolkata – 700 091.
Tel: +91 33 4403 4000

Mumbai
2nd Floor, Block T2 (B Wing),
Lodha Excellus, Apollo Mills Compound, N M
Joshi Marg, Mahalaxmi, Mumbai- 400011
Tel: +91 22 3989 6000

Noida
Unit No. 501, 5th Floor,
Advant Navis Business Park,
Tower-A, Plot# 7, Sector 142,
Expressway Noida,
Gautam Budh Nagar,
Noida – 201 305.
Tel: +91 0120 386 8000

Pune
9th floor, Business Plaza,
Westin Hotel Campus, 36/3-B,
Koregaon Park Annex,
Mundhwa Road, Ghorpadi,
Pune – 411 001.
Tel: +91 20 6747 7000

Vadodara
Ocean Building, 303, 3rd Floor,
Beside Center Square Mall,
Opp. Vadodara Central Mall,
Dr. Vikram Sarabhai Marg,
Vadodara – 390 023.
Tel: +91 265 619 4200

Vijayawada
Door No. 54-15-18E,
Sai Odyssey,
Gurunanak Nagar Road, NH 5,
Opp. Executive Club, Vijayawada,
Krishna District,
Andhra Pradesh – 520 008.
Tel: +91 0866 669 1000

home.kpmg/in

#KPMG josh

home.kpmg/in/socialmedia