Tax Hotline

October 10, 2018

MUMBAI TRIBUNAL: ASSET BASED VALUATION NOT APPLICABLE TO PREFERENCE SHARES

- Tribunal refuses to accept the calculation of fair market value of redeemable preference shares based on net worth of the issuing company.
- Rules that preference shares and equity shares are different in substance for the purposes of valuation.
- Rejects argument that premium which is in excess of fair market value can be taxed as an unexplained cash credit under Section 68 of the ITA.

Recently, in *ACIT vs. Golden Line Studio Pvt. Ltd*,[1] the Mumbai Bench of the Income Tax Appellate Tribunal ("**Tribunal**") ruled that for the purposes of determining whether excessive premium has been charged on the issue of redeemable preference shares ("**RPS**"), the fair market value ("**FMV**") of the RPS which is determined to ascertain the taxable amount, should not be calculated on the basis of the net asset value ("**NAV**") of the issuing company. In doing so the Tribunal has made a clear distinction between the valuation of equity shares and the valuation of preference shares, appreciating that they both stand on a different footing. The ruling further clarifies that solely because premium charged is perceived as excessive, it cannot be considered as unexplained in nature for the purposes of taxation of unexplained cash credits under Section 68 of the Income Tax Act ("**ITA**").

BACKGROUND

The taxpayer, Golden Line Studio Pvt. Ltd ("**GLSPL**") is an Indian company engaged in the business of film production. In the financial year 2010-11, GLSPL issued non-cumulative, non-convertible RPS having face value of INR 10 each for a price of INR 500 per share, to its holding company Sahara India Commercial Corporation Limited ("**SICCL**"). The said RPS were redeemable at a fixed price of INR 750 after the expiry of five years from their date of issue, thereby providing a return of approximately 10% over the said period of 5 years. Although the RPS were issued in the financial year noted above, the consideration for the same had been received in previous years.

At the first stage of assessment, the Assessing Officer ("**AO**") treated the issue price of INR 500 as excessive in relation to the FMV of the shares. The AO determined the FMV of the shares using the NAV method and concluded that the FMV should be INR 38 per share and consequently the reasonable premium should have been INR 28 per share and not INR 490 as calculated by GLSPL. It was GLSPL's contention that unlike equity shares, the value of preference shares is not linked to the intrinsic value of the company's assets and thus they should not be valued on the basis of the company's NAV. GLSPL further argued that while equity shares represent rights in the assets of a company and a return on equity shares is dependent on the current value of the company's assets, a return on preference shares is fixed whether in terms of dividend or at the time of winding up. Further, preference shares differed in substance since they get a preference over equity shareholders on payment of dividend and repayment of equity. Thus, GLSPL reasoned that preference shares are akin to quasi debt instruments and should be valued based on the returns they fetch and not the company's NAV, since a preference share redeemable at a premium of 10%, would be redeemable at that price at the time of redemption, irrespective of the value of the assets of the company at that time. The AO however rejected these contentions and sought to tax the excess premium of INR 462 per share (INR 490 – INR 28) in the hands of GLSPL.

Aggrieved by this order, GLSPL appealed to the Commissioner of Income-tax (Appeals) ("**Commissioner**"), who reversed the order of the AO. The Commissioner agreed with GLSPL that the share premium amount of INR 490 had been determined on a reasonable basis, because considering the fixed return of INR 750 on redemption, the issue price of INR 500 provided a reasonable return of 10% over five years. The Commissioner also noted that the share premium was a capital receipt and should thus not be taxable. He further observed that although the AO had not proceeded under any particular provision of the ITA in its order, the valuation of shares appeared to have been done as per

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the provisions of Section 56(2)(viib) of the ITA read with Rule 11UA of the Income Tax Rules ("**ITR**"). Section 56(2)(viib) brings to tax premium charged by a company on issue of shares above their face value, to the extent that the consideration received for such shares exceeds the FMV of the shares, and Rule 11UA contains provisions for the calculation of FMV of property for the purposes of Section 56[2].

Aggrieved by the order of the Commissioner, the tax department ("**Revenue**"), filed an appeal before the Tribunal.

RULING OF THE TRIBUNAL

The Tribunal ruled in favor of the taxpayer. It agreed that equity shares and preference shares stand on a different footing by holding that the NAV of a company in fact represents the value of equity shares and not preference shares. The Tribunal appreciated that preference shares differ in substance since they get a preference over the equity shareholders and because preference shareholders are not the real owners of the company.

The next question dealt with by the Tribunal was on the applicability of Section 68 of the ITA as it was the Revenue's contention that the AO had impliedly proceeded under Section 68 of the ITA. Section 68 of the ITA levies tax on all unexplained cash credits.[3] On this argument, the Tribunal observed that there existed no doubt as regards to the source of income, while in relation to the nature of income it was evident that it was in the form of share premium. It noted that the Revenue had sought to tax the premium under Section 68 only on the ground that the share premium was in excess of its book value and therefore the 'nature' of the income relating to the excess premium had not been proved. However, the Tribunal did not agree with this view and further observed that the very basis of considering the share premium as excess was by valuing it based on the book value of the shares which was not sustainable. It noted that there in fact existed a commercial rationale for issuing the shares at INR 500 when the repayment of the same was expected to be at INR 750 after a period of five years. Therefore, the Tribunal concluded that the premium could not be taxed under Section 68 of the ITA since both the nature and source of the entire income were satisfactorily explained. It also accepted the contention of the taxpayer that Section 68 of the ITA is only applicable in the year the funds are received and therefore would be inapplicable in the current case where the shares were only allotted in the relevant financial year while the funds had been received in prior years.

ANALYSIS

The decision of the Tribunal is certainly a welcome one and provides reassurance to companies, especially start-ups, looking to raise large capital by issuance of preference shares at a premium. From an investor's perspective, generally RPS are preferred since they provide a lower risk and an assured return. Further, it is also well settled that the issue of shares at a premium is a commercial decision which is the prerogative of the Board of Directors and the subscribing shareholders and does not require any justification.[4] Generally, companies which have not commenced business do not have the benefit of high net worth due to non-establishment of profitability, credibility, goodwill etc and use the preference share route to raise capital.

Taxability of Share Premium

An argument made by GLSPL and accepted by the Commissioner was that share premium is a capital receipt and therefore should not be taxed. Although the ruling did not specifically deal with this aspect, it is an accepted proposition of law that capital receipts, unless specifically taxed under any provision of the ITA, are excluded from taxable income. It has also been well settled that share premium realized from the issue of shares is capital in nature and forms part of the share capital of the company and therefore cannot be taxed as a revenue receipt.[5]

Valuation of RPS

The Tribunal has proceeded on a sound footing when it held that preference shares, unlike equity shares, cannot be valued using NAV. The distinction between them becomes more evident in the case of RPS which are redeemable at a fixed price after a fixed period of time and thus cannot be considered dependent on the asset value of the company at the time of redemption.

Further, under Rule 11UA of the ITR the calculation of FMV of preference shares is based on an open market valuation whereas the NAV method is used for valuing equity shares. Therefore, had the AO proceeded under Section 56(2)(viib), even under the prescribed rules under the ITA, it may not have been right to value the RPS based on NAV.

Interestingly, the argument that RPS are actually quasi debt instruments was raised recently before the Kolkata bench of the Tribunal in *Microfirm Capital Pvt. Ltd v. DCIT*[6], wherein the very applicability of Section 56(2)(viib) to RPS was questioned. The taxpayer in this case contended that considering that RPS are similar to debt and since in an issue of RPS a company is bound to return the money to the shareholders as per contractual terms, the RPS should not be covered under the provision of Section 56(2)(viib), which the taxpayer argued was introduced to deal only with equity shares. However, the Tribunal clarified that Section 56(2)(viib) covers all shares, including RPS and thus they would also be subject to tax under it, irrespective of their nature.

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Another interesting argument that tax authorities have tried to make in relation to valuation of shares under Rule 11UA of the ITR, is that if the open market value of shares is available then the same should be used for valuation purposes, irrespective of the fact that another method has been specifically prescribed under the rules. This issue came up in *Medplus Health Services Pvt. Ltd vs ITO*[7] wherein the taxpayer had calculated the FMV of unquoted equity shares based on the formula provided under Rule 11UA, but the AO proceeded to determine the FMV based on the open market value. The AO's reasoning was that the valuation of any property is actually dependent on its open market value, but since generally the details as to the market value for unlisted shares is not available, a formula is provided under Rule 11UA of the ITR to overcome the deficiency. Therefore, when the market value, i.e. price at which certain persons in the market are ready to purchase the shares, is available, the tax authorities contended that it should be used over other valuation methods. However, the Hyderabad bench of the Tribunal did not agree with this view and concluded that the AO had to follow the particular method prescribed under the law and the same cannot be ignored.

Valuation of RPS under Section 68

Additionally, it also becomes important to understand what would be the appropriate valuation method of the FMV under Section 68 of the ITA. This is because, unlike Section 56 of the ITA, Section 68 does not contain a specified methodology for valuation of property. The Tribunal did not dwell into this aspect once it had established that there was commercial rationale behind the amount of premium charged on the preference shares and that the same could not be considered excessive. Notably, in arriving at this conclusion, the Tribunal valued the FMV of the shares based solely on the returns the shares would provide and not on a prescribed valuation method.

Interestingly, in this regard, Section 68 of the ITA falls under Chapter VI of the ITA relating to "Aggregation of Income' and not under Chapter IV which relates to 'Computation of Income,' under which income is computed under various heads, including 'income from other sources', i.e. Section 56. Arguably, once it is established that the premium cannot be taxed as unexplained cash credits under Section 68, the taxability of the premium should be determined as per the provisions of Chapter IV under the appropriate head of income, i.e. Section 56. Consequently, the valuation methodology for determining the FMV under Section 56 should then become applicable.

This question of relating back Section 68 to Section 56 came up in *Sunrise Academy of Medical Specialities (India) Pvt. Ltd. v. ITO*[8]*,* a similar case decided by the Kerala High Court. In this case the Court confirmed that if a satisfactory explanation is offered under Section 68 of the ITA by virtue of which Section 68 is made inapplicable, the premium amount in question should then be brought to tax as income from other sources under Section 56 of the ITA.

This position is also supported by a ruling of the Chandigarh bench of the Tribunal in ITO v. Dulari Digital Photo Services Pvt. Ltd[9]. However, in this case the Tribunal went a step further and clarified that where the nature and source of the income are not satisfactorily explained, the same should be taxed under Section 68 itself and not under the various sources/heads of income under the ITA. Thus, even though the Tribunal had a similar conclusion as the Kerala High Court in relation to cases where satisfactory explanation is provided under Section 68 of the ITA, for cases where a satisfactory explanation is not provided it ruled that the income has to be taxed under the specific provisions of Chapter VI. Although this reasoning has merit, in the absence of a computation mechanism under Section 68 and generally Chapter VI, clarity may be required on how the income is to be computed and taxed.

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You can direct your queries or comments to the authors

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[1] I.T.A.No.38 of 2014

[2] For the purposes of calculating FMV under Section 56, Rule 11UA of the ITR provides valuation methodology for equity shares as well as preference shares. Rule 11UA(1)(c)(c) provides that the FMV of preference shares should be the price the shares would fetch if sold in the open market on the valuation date.

[3] Under Section 68 of the ITA where an assessee is unable to satisfactorily explain the 'nature' and the 'source' of any credit entry in its books, the sum reflected in the entry is liable to income tax.

[4] *Green Infra Ltd. v. ITO* [2013 145 ITD 240 (Mum Trib.)]; *Motisons Entertainment (India) Pvt. Ltd v. ACIT* [MANU/IJ/0140/2017]

[5] *Vodafone India Services Pvt. Ltd. v. Union of India* [(2014) 368 ITR 1]

[6] [2018] 62 ITR(T) 109 (Kolkata - Trib.)]

[7] [2016] 158 ITD 105 (Hyd)

[8] [2018] 96 taxmann.com 43 (Kerala)

[9] *ITO v. Dulari Digital Photo Services Pvt. Ltd* [[2012] 53 SOT 210 (Chandigarh)(URO)]

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