Taxsutra Eye Share: Demystifying Applicability of Sec. 56(2)(viib) on Preference Shares

Jun 04,2020

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Section 56(2)(viib) of the Income Tax Act, 1961 ('the Act') was introduced by the Finance Act, 2012, seeking to tax any excess premium received by a closely held company upon the issue of shares. Such excess premium is deemed to be the income of the company and shall be taxed under section 56(2)(viib) of the Act of the Act.

The intent of the legislature in enacting these provisions was to discourage the practice of subscription to shares of closely held companies at excessive and unjustifiable premium, adopted by tax payers.

Practically, most of us have dealt with the applicability of this section during the assessment proceedings on the issue / allotment of equity shares by a company, so much so that the issuance of equity shares and the topic of "Angel Tax" has been the point of convergence of various CBDT Circulars / Notifications. Even though this section and the respective Circulars / Notification tables various stipulations and challenges on the issuance of Equity Shares, an oblivion is created when it concerns issuance of "preference shares".

Accordingly, this article attempts to bring congruence to the Yet Unfettered topic of applicability of section 56(2)(viib) of the Act on the issuance of Preference Shares. Having established the applicability, the article then seeks to earnestly throw light upon the method(s) of valuation of the FMV('FMV') of such preference shares, in line with the pari-materia provision for equity shares under Rule 11UA of the Income Tax Rules, 1962 ('the Rules').

Part I - Applicability of Section 56(2)(vii) on Preference shares

This part seeks to analyze the applicability of this section on the issuance of preference shares.

<u>*Analysis - Statutory Position*</u>

For an ease in reference to the present debatable topic, the relevant extract of section 56(2)(viib) of the Act is reproduced as under:

"*(2) In particular, and without prejudice to the generality of the provisions of sub-section (1), the following incomes, shall be chargeable to income-tax under the head "Income from other sources", namely:—*

...

(viib) where a company, not being a company in which the public are substantially interested, receives, in any previous year, from any person being a resident, any consideration for issue of shares that exceeds the face value of such shares, the aggregate consideration received for such shares as exceeds the FMVof the shares"

On a plain reliance, it could be perceived that the provision does not being any distinction between equity and preference shares. The Act uses the term "Shares", which would automatically imply both equity and preference, thus bringing justice to the first question under consideration.

<u>Judicial Precedents</u>

In the case of **<u>Ginni Global (P.) Ltd. v. ACIT 1</u>** , it was decided by the **Hon'ble Jaipur Tribunal** that section 56(2)(viib) of the Act does not make any distinction between equity shares and preference shares.

In the case of **Microfirm Capital (P.) Ltd. v. DCIT2** , it was contended by the assessee that section 56(2)(viib) of the Act was brought into the statute with an objective to deter generation and use of unaccounted money through infusion of fund from shareholders by way of share premium in excess of fair market value. It was argued that the Redeemable Preference Shares, being quasi debt instruments, are not covered by the provisions of Section 56(2)(viib) of the Act. In furtherance, it was submitted that in the case of a redeemable preference shares, the company is bound to return the money as per the contract, which is similar to any debt instrument. It was contended that raising capital is very much necessary for economic growth, industrial development and increase in employment of the country and therefore, purposive and liberal interpretation has to be given to the section in cases where the company is bound to return the money which it received by way of redeemable preference shares. Hence, the assessee supported that the section should not be applied on such preference shares.

The **Hon'ble Kolkata Tribunal** rejected this contention of the assessee and held as below.

"*A perusal of Section 56(2)(viib) of the Act of the Act, takes us to a conclusion that all types of shares are covered by this Section. The argument of the assessee that RNCPS is a quasi-debt and that it was not the intention of the legislature to bring such instruments within the ambit of this Section, is devoid of merit. We also do not find any merit in the arguments of the ld. Counsel for the assessee that economic consideration that are related to capital formation, employment, industrialization etc. should lead to purposive and liberal interpretation of the Section. RNCPS cannot be excluded from the ambit of Section 56(2)(viib) of the Act of the Act. Hence, we reject these argument of the ld. Counsel for the assessee.*"

Therefore, the judicial precedents rest the argument in favor of applicability of Sec 56(2)(viib) of the Act to both cases, thereby drawing a parity on taxation on issue of equity and preference shares.

Part II - Valuation of FMV of Preference Shares, for Section 56(2)(viib) of the Act

Since the applicability of the provisions of Sec 56(2)(viib) of the Act stands affirmative on preference shares, it is imperative to now examine the valuation aspects concerning FMV of preference shares.

Analysis - Statutory Position

The valuation of Equity Shares is governed by Rule 11UA of the Rules, which prescribes the determination of FMV for the purpose of section 56 of the Act. Sub-clause (c) of clause (c) of Rule 11UA(1) provides for determination of FMV of unquoted shares and securities other than equity shares. Thus, by inference , as this clause categorically excludes equity shares, it should include all other securities such as preference shares as well.

Now, this rule states that the FMV shall be estimated to be the price fetchable by the security, had it been sold in the open market on the valuation date. Further, the rule mandates obtaining a valuation report from a merchant banker or an accountant, to determine the basis of such valuation on the valuation date. Therefore, it is apparent that the Rules cover valuation of preference shares, thereby answering the second question.

However, it is important to note that while the Rules amply cover the valuation of Preference Shares, they do not provide any straight jacket formula or method giving a definitive computation mechanism for such valuation, as in the case of Equity shares.

Therefore, in the absence of such guiding method, one would have to take recourse to the surrounding judicial precedents on this issue.

Judicial Precedents

In the case of **Ginni Global (P.) Ltd** . (cited supra), the assessee used a hybrid method, wherein, the FMV of the preference shares was computed by assigning weights to the FMV determined by both Discounted Free Cash Flows ('DCF') method and Net Asset Value ('NAV') method. The Assessing Officer ('AO') adopted the value as per NAV method and computed FMV, thereby making addition of the differential amount.

From the judgement, it can be largely inferred that while the Revenue in-turn could not bring out any definitive formula or method, the AO did accept the NAV method applied by the assessee and hence, it was not questioned at any appellate forums.

Therefore, even though the addition stood confirmed by the revenue, a reasonable precedent gets established as to the applicability of NAV method in derivation of value of preference share.

In the case of **Microfirm Capital (P.) Ltd** . (cited supra), the assessee determined the FMV by using DCF method and obtained a valuation report from an independent accountant. This method was not questioned by the Revenue at any level, as instead, the litigation zoomed on determination of the closed accurate discounting factor to be used in the method.

Again, it is essential to state that the Revenue assented to the applicability of DCF for the purpose of computing NAV of preference shares.

In **ACIT vs. Golden Line Studio Pvt. Ltd.3** , the assessee issued Non-convertible Redeemable Preference shares to its holding company at Rs. 500 per share (Rs. 10 Face value and Rs. 490 Premium). During the assessment proceedings, on being asked by the AO to justify such huge premium, the assessee explained that the shares are redeemable at Rs. 750 per share, down the line five years. Thus, the said investment would fetch approximately 10% return per annum over a period of five years. It was also explained that preference shares are like quasi-debt instruments whereas equity shares are nothing but participating rights of the shareholders in the company. It was contended that the valuation of equity shares is dependent on the intrinsic value of the company as they have rights in assets / funds of the company. At the time of liquidation, an equity share of Rs. 10 may even fetch Rs. 1000 on winding up of a company if sufficient funds are left for the equity shareholders. However, preference shares being quasi debt instruments do not have such rights and at the most would receive face value of the preference shares and premium (which is decided at the time of issue of shares) on redemption / winding up.

The AO rejected the contention of the assessee and took the view that the share premium amount is on the higher side. Accordingly, he calculated the FMV of the shares at Rs. 38 per share based on NAV method and added the excess premium to the income of the assessee. On appeal, the CIT(A) held that the FMV determined by the assessee is justified since the preference shares are redeemable at Rs.750 per share after five years. On further appeal by revenue, the Hon'ble ITAT observed that the preference shares and equity shares stand on different footing. While the equity shareholders are the real owners of the company, the preference shareholders are not in fact, the owners of the company. They get preference over the equity shareholders on payment of dividend and repayment of equity. Hence, the NAV of the company represents the value of equity shares and not preference shares. It was also observed that the transaction did include commercial consideration since shares are redeemable at Rs. 750, accordingly, the view of the AO to determine FMV by applying the NAV method is not sustainable. The order of the CIT(A) was upheld by the Hon'ble Tribunal and hence, the additions were deleted.

From this judgement it can be inferred that in the case of issue of preference shares, no specific method is prescribed by the Act / Rules and it is open to the assessee to compute the FMV of the shares as per any method keeping in view commercial consideration of the transaction.

In light of the above discussion, it can be deduced that the provisions of Sec 56(2)(viib) of the Act are applicable to Preference Shares. However, there is no specific prescribed method for valuation of such preference shares.