



Tax alert: Deemed income provisions not applicable on conversion of outstanding loan to shares

8 July 2024

The Himachal Pradesh High Court has rendered its decision that loans received by the taxpayer in earlier years, but converted to shares in the current year, will not fall under the definition of 'any consideration for issue of share received in the previous year' and therefore will not attract the provisions of section 56(2)(viib) of the Income-tax Act, 1961. Further, it held that the right to select the valuation method vests with the taxpayer and the Assessing Officer can only verify valuation method adopted by the taxpayer but cannot substitute it by a different method.

In a nutshell



No consideration was received by the taxpayer for allotment of the shares. Therefore section 56(2)(viib) of the Income-tax Act, 1961 did not apply, and that it applied **only if consideration was received** for such a transaction.



The Assessing Officer has no jurisdiction to substitute the method of assessing the valuation of shares once the taxpayer had exercised the method under Rule 11UA(2) of the Income-tax Rules, 1962.



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Background:

- The taxpayer¹ is an Indian company (converted from partnership firm to a company) engaged in the business of generation and distribution of hydroelectricity in the state of Himachal Pradesh, India, and filed its return of income for the Financial Year (FY) 2017-18, corresponding to Assessment Year (AY) 2018-19, declaring certain loss.
- During the year under consideration, the taxpayer had issued certain equity shares with at a premium to two Indian entities.
- The taxpayer was having certain opening balance of unsecured loans as on 1 April 2017, which was converted into share capital. Both the share subscriber entities were partners in the taxpayer firm and the balances were showing as Partners Capital account.
- The taxpayer valued the aforesaid equity shares as per Discounted Cash Flow (DCF) method as prescribed under rule 11UA of the Income-tax Rules, 1962 (Rules) and a certificate was also obtained from a Chartered Accountant, as required under the aforesaid Rules.
- The Assessing Officer (AO), during audit proceedings:
 - Made addition of income under the head 'Income from Other Sources' under section 56(viib) of the Income-tax Act, 1961 (ITA) [relating to income in hands of taxpayer company on issue of shares in certain cases] on account of excess amount per share paid as premium.
 - Rejected the valuation report furnished by the taxpayer on the basis that the DCF valuation used by the taxpayer was bogus and had no connection with the real figures. The AO held that the valuation was done with fictitious figures having no correlation with actual affairs of the taxpayer.

Accordingly, the AO computed the fair market value (FMV) of the shares on the basis of balance sheet figures as per Net Asset Value (NAV) method.
- Aggrieved, the taxpayer filed an appeal before the Commissioner of Income-tax (Appeals) [CIT(A)], which deleted the addition made by the AO.
- Aggrieved by this, the Revenue authorities filed an appeal before the Chandigarh bench of the Income-tax Appellate Tribunal (ITAT). The ITAT confirmed the CIT(A) i.e. the first Appellate authority's finding and held that:
 - The taxpayer did not receive any consideration for allotment of shares in the year under consideration (i.e. the current FY 2017-18 corresponding to AY 2018-19) and hence, if no consideration was received in the year under consideration, section 56(2)(viib) of the ITA had no application.
 - The consideration in the form of unsecured loans was received from the partners of the erstwhile firm in the year 2010, and the AO could not bring out any material facts to show that such conversion of loans to equity shares was a ploy to defraud Revenue of the tax on such transaction.
 - The AO could only verify method of valuation adopted by the taxpayer, but the same could not be substituted by the AO by a different method i.e., NAV method, once the taxpayer exercised option for the DCF valuation method.
 - The AO was not correct in rejecting the DCF method and proceeding to value the shares by NAV method merely on the ground that there was a huge difference in projected figures and actual results available for some years, relying on earlier ruling² of the Mumbai ITAT.

¹ PCIT-1, Chandigarh vs. M/s I.A. Hydro Energy (P) Limited [2024] ITA No. 4 of 2024 (Himachal Pradesh - HC)

² Creditalpha Alternative Investment Advisors (Pvt.) Ltd. (2022) 134 Taxmann.com 223 (Mumbai- ITAT)

- Aggrieved by the aforesaid ITAT's order, the Revenue filed an appeal before the Himachal Pradesh High Court (HC).

Relevant provisions in brief:

Extracts of Section 56(2)(viib) of the ITA:

“Section 56(2)(viib) - where a company, not being a company in which the public are substantially interested, receives, in any previous year, from any person, 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 of the shares.....”

Decision of the HC:

The HC agreed with the observation / reasoning adopted of the ITAT and the CIT(A) that:

- No consideration was received by the taxpayer for allotment of the shares. Therefore section 56(2)(viib) of the ITA did not apply, and that it would have applied **only if consideration was received** for such a transaction.
- The AO had no jurisdiction to substitute the NAV method of assessing the valuation of shares, once the taxpayer had exercised option of a DCF valuation method under Rule 11UA(2) of the Rules.

Accordingly, the HC held that no question of law arose and the appeal filed by the Revenue was to be dismissed.

Comments:

Indian companies, in which public are not substantially interested, may issue/allot shares for various reasons such as raising funds for working capital purpose, expansion of business, diversifying ownership, etc. It may also allot shares for conversion of existing loan such that debt is converted into equity for commercial considerations.

As per provisions of section 56(2)(viib) of the ITA, any consideration received for issue of equity shares in excess of FMV of the shares, shall be chargeable to tax under the head 'Income from other sources'. However, there may arise controversy as to whether issuance of shares on account of conversion of loan into equity would attract provisions of section 56(2)(viib) of the ITA or not?

The HC in this ruling, while upholding the ITAT and CIT(A)'s order, reiterated the following principles:

- No consideration was received by the taxpayer for allotment of the shares, therefore section 56(2)(viib) of the ITA did not apply, and that it applied **only if consideration was received** for such a transaction.
- The AO has no jurisdiction to substitute the method of assessing the valuation of shares once the taxpayer had exercised the method under Rule 11UA(2) of the Rules.

Taxpayers with similar facts may want to evaluate the impact of this ruling to the specific facts of their cases.

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