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Book value methodology cannot be used in case of preference shares to calculate excess premium received

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Facts of the case

- M/s Golden Line Studio Pvt. Ltd. (GLS) [the assessee], was engaged in the business of film production in the field of providing visual effects and animation facilities.
- The assessee had issued non-convertible and non-redeemable preference shares to its holding company M/s Sahara India Commercial Corporation Limited (SICCL). These shares were issued on 1 April 2010, each at the price of Rs 500/- having face value Rs 10/-. Accordingly, the shares were issued at a premium of Rs.490/-. Funds had been received by the assessee in the earlier years. During the year under consideration, the assessee had merely transferred the funds to 'preference share account' and 'share premium account'.
- The Assessing Officer (AO) asked the assessee to justify the premium collected on the issue of preference shares.
- The assessee contended that the preference shares are 'quasi-debt instruments'; and they stand on different footing from equity shares and hence the tests applied to equity shares, should not be applied to preference shares.
- The AO took the view that the Fair Market Value (FMV) of unquoted shares should be determined on the basis of balance sheet of the assessee. Based on the balance sheet, the AO calculated the FMV to be Rs 38/- per share. However, he considered reasonable premium to be Rs. 28 per share and took the view that excess premium of Rs. 462 (490-28) per share, which worked out to Rs. 28.22 crores, was to be assessed as income of the assessee.
- The Commissioner of Income-tax Appeals (CIT-A) deleted the additions made by the AO on the ground that the valuation and the charging provisions relied upon by the AO were not applicable for the year under consideration. Further, the CIT-A accepted the contention of the assessee that the share premium is a capital receipt by taking the support of Bombay High Court (HC) ruling in the case of *Vodafone India Services P. Ltd.*

Issue under consideration

Whether the valuation methods to determine the Fair Market Value (FMV) of the unquoted equity shares can be applied to determine the FMV of unquoted preference shares?

Ruling of the tribunal

- The Mumbai Income-tax Appellate Tribunal (Tribunal) noticed that the AO has failed to appreciate the fact that preference shares and equity shares stand on different footing.

- The Tribunal observed that equity shareholders were the real owners of the company and preference shareholders were not in fact, the owners of the company.
- Preference shareholders get preference over equity shareholders on payment of dividend and repayment of equity. Hence the net asset value of the company really represents the value of equity shares and not that of preference shares.
- The Tribunal observed that the AO had not taken support of any of the provisions of the Act to assess the alleged excess premium. Accordingly, the Tribunal held that no receipt can be assessed to income-tax unless there is authority under the law to assess the same.
- In respect of the Revenue's contention that the assessee had failed to prove the nature of receipt, the Tribunal held that the Revenue had suspected 'nature' of receipt only for the reason that the book value of share stood at Rs. 38/- per share only. However, the 'nature' of receipt of share premium cannot be doubted merely on the basis that the share premium was in far excess of book value, as equity shares and preference shares stand on a different footing.
- The Tribunal noted the fact that the assessee had explained the 'nature' of the transaction as share premium, which was not contradicted by Revenue, and there was no dispute with regards to the 'source' of the receipt. Hence, the provisions for unexplained cash credit as per the Act, could not be considered in the assessee's case. The Tribunal further noted that provisions for unexplained cash credit shall apply only in the year in which the funds were received.
- The Tribunal held that the book value of shares would value only equity shares, and not preference shares. Hence, the very basis on which the AO determined excess premium, was not sustainable.

Conclusion

This ruling lays down that the methodology adopted for valuing equity shares may not be applicable for valuing preference shares. For the year under consideration, there was no prescribed valuation methodology under the Act for valuing either the equity shares or the preference shares.

Currently, the income-tax law provides that fair market value of preference shares is prescribed to be the price it would fetch in the open market (a report from a merchant banker or an accountant could be obtained in relation to the same).

Separately, the Tribunal has also clearly held that the provisions for unexplained cash credit shall apply only in the year in which the funds were received.

It may be noted that there has been no discussion around the fact that the assessee had issued non-convertible and non-redeemable preference shares.

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