# *Issue of shares – out of TP rigours – Rules Bombay High Court*

*October 12, 2014*

## *In brief*

The much-awaited ruling of the Bombay High Court (HC) in the context of the Writ Petition filed by Vodafone India Services Private Limited (VISPL or the taxpayer) has been released. The taxpayer had challenged the following transfer pricing (TP) adjustments made by the Revenue:

- alleged undervaluation of shares issued by VISPL in favour of its Associated Enterprise (AE); and
- imputing of notional interest on such alleged undervaluation of shares, by treating the shortfall as loan advanced by VISPL to its AE.

The taxpayer in the first Writ Petition (WP No.1877 of 2013) challenged these adjustments as being patently illegal and without jurisdiction. This was on the ground that the purported undervaluation could never have been brought under the ambit of taxation by taking course to TP, as the same was on capital account. The HC directed the Dispute Resolution Panel (DRP) to decide the taxpayer's preliminary issue of jurisdiction. Consequent to this direction, the taxpayer made it submissions before the DRP. However, the DRP held the alleged undervaluation of shares as 'income' chargeable to tax. Further, it imputed notional interest on such alleged undervaluation by treating it as deemed loan.

Against the said order of the DRP, the taxpayer filed a Second Writ Petition before the HC. In this Second Writ proceeding, the Bombay HC categorically held that issue of shares at a premium by the VISPL in favour of its AE did not give rise to any "income" from an International Transaction, and therefore, there was no need to invoke TP provisions.

## *In detail*

***Facts***

- On August 21, 2008, VISPL[1] issued 2,89,224 equity shares of the face value of INR 10 each at a premium, at INR 8,509 per share to its AE. This resulted in VISPL receiving a total consideration of INR 2.46 billion from its AE on issue of shares. The fair market value of the equity shares at INR 8,519 per share was determined by VISPL in accordance with the Capital Issues (Control) Act, 1947.
- However, according to the Tax Officer (TO) and Transfer Pricing Officer (TPO), VISPL ought to have valued each equity share at INR 53,775, and hence, the shortfall in premium to the extent of INR 45,256 per share resulted into total shortfall of INR 13.09 billion.
- Both, the TPO and the TO held, on application of the TP provisions contained in Chapter X of the Act, that this amount of INR 13.09 billion was income chargeable to tax in the hands of VISPL.
- They further held that this amount of INR 13.09 billion was required to be treated as deemed loan given by VISPL to its AE, and periodical interest thereon was to be charged to tax as interest income of INR 883.5 million in the Financial Year 2008-09 i.e. Assessment Year 2009-10.

[1] Vodafone India Services Private Limited *v.* UOI (WP No.871 of 2014, Bombay HC)

***Issue before the HC***

Whether the alleged shortfall in share premium arising out of the transaction of the issue of shares by VISPL to its AE constituted 'income' in the hands of VISPL chargeable to tax under the Act?

***Decision of the HC***

*Scope/ objective of Transfer Pricing Provisions*

- A plain reading of section 92(1) of the Income-tax Act, 1961 (the Act) very clearly brought out that "income" arising from an International Transaction was a condition precedent for application of Chapter X of the Act.
- Transfer Pricing provisions in Chapter X of the Act were to ensure that in case of International Transaction between AEs, neither the profits were understated, nor losses overstated. They did not replace the concept of Income or Expenditure as normally understood in the Act, for the purposes of Chapter X of the Act.
- The objective of Chapter X of the Act was certainly not to punish Multinational Enterprises and/ or AEs for doing business *inter se*.
- Arm's length price (ALP) was meant to determine the real value of the transaction entered into between AEs. It was a re-computation exercise to be carried out only when income arose in case of an International transaction between AEs. It did not warrant re-computation of a consideration received/ given on capital account.

*Income under section 2(24) – whether includes capital receipt?*

- It could not be disputed that income would not in its normal meaning under the Act include capital receipts unless specified[2].
- The amount received on issue of shares was admittedly a capital account transaction not separately brought within the definition of Income, except in cases covered section 56(2)(viib)[3] of the Act. Therefore, absent express legislation, no amount received, accrued, or arising on capital account transaction could be subjected to tax as income.
- Parliament had consciously not brought to tax amounts received from a non-resident for issue of shares, as it would discourage capital inflow from abroad.
- Neither the capital receipts received by the tax payer on issue of equity shares to its AE, a non-resident entity, nor the alleged shortfall between the so called fair market price of its equity shares and the issue price of the equity shares, could be considered as "income" within the meaning of the expression as defined under the Act.
- A transaction on capital account or on account of restructuring would become taxable to the extent it impacts income, i.e., under-reporting of interest received or over-reporting of interest paid or claim of depreciation, etc. It was only that income which had to be adjusted to the ALP.
- The issue of shares at a premium was a capital account transaction and not income.

*Notional income v. Real income*

Reliance by the Revenue upon the definition of International Taxation in sub clauses (c) and (e) of Explanation (i) to section 92B of the Act to conclude that Income had to be given a broader meaning to include notional income, as otherwise Chapter X of the Act would be rendered otiose/ meaningless, was held to be far-fetched.

*Provisions of Chapter X – whether charging or machinery provisions?*

- In the absence of a charging Section in Chapter X of the Act, it was not possible to read a charging provision into Chapter X of the Act[4].
- Chapter X of the Act was a machinery (computational) provision to arrive at the ALP of a transaction between AEs.
- The substantive charging provisions were in sections 4, 5, 15 (Salaries), 22 (Income from house property), 28 (Profits and gains of business), 45 (Capital gain) and 56 (Income from other Sources). Even income arising from International Transactions between AEs had to satisfy the test of Income under the Act and had to find its home in one of the above heads, i.e., charging provisions.

[2] Followed the decision of the Bombay High Court in Cadell Weaving Mill Company Private Limited *v.* CIT [2001] 249 ITR 265 (Bombay) upheld by the Apex Court in CIT *v.* D.P. Sandu Brothers Chembur Private Limited. [2005] 273 ITR 1 (SC)

[3] Section 56(2)(viib) of the Act seeks to tax a Company in which public are not substantially interested, in respect of the consideration received from a resident on sale of shares, which is in excess of the fair market value of the shares, as Income from other sources.

[4] Followed the five Member Bench of the Apex Court in CIT *v.* Vatika Township Private Limited [2014] 49 taxmann.com 249 (SC)

### *Revenue's reliance on section 92(2) of the Act*

Section 92(2) of the Act dealt with a situation where two or more AEs entered into an arrangement whereby, if they were to receive any benefit, service or facility, then the allocation, apportionment or contribution towards the cost or expenditure had to be determined in respect of each AE having regard to the ALP. It would have no application in VISPL's case where there was no occasion to allocate, apportion or contribute any cost and/ or expenses between the tax payer and the AE.

### *Revenue's reliance on section 56 of the Act – Income from other sources*

Although section 56(1) of the Act would permit including within its head all income not otherwise excluded, it did not provide for taxing a capital account transaction of issue of shares as was specifically provided for in section 45 or section 56(2)(viib) of the Act and included within the definition of income in section 2(24) of the Act.

### *Conclusion*

Issue of shares at a premium by VISPL to its AE did not give rise to any "income" from an International Transaction. Therefore, there was no need to invoke TP provisions.

## *The takeaway*

The judgement delivered by Bombay High Court in favour of the tax payer saves it from the rigours of the ongoing high-pitched TP litigation. It is a welcome judgment as the transaction of issue of shares by VISPL was nothing but a capital account transaction, and consequently the share premium, if any, ought to be a capital receipt. The transfer pricing provisions permit a transaction to be re-quantified but not to be re-characterised. Hence, there was no question of the transaction resulting in 'income' taxable in India. The judgment will not only serve as a precedent in the legal arena but will also lend a much needed boost to foreign investors. The judgement brings relief to numerous companies who are saddled with such unnecessary adjustments. It is timely in view of our Prime Minister's invitation to the world to manufacture and invest in India. This will certainly help in boosting the "Make in India" campaign and the overall investment climate of the country.

## *Let's talk*

For a deeper discussion of how this issue might affect your business, please contact:

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