Tribunal holds that section 56(2)(viib) applies to all class of shares and that TO could challenge the valuation report submitted for the computation of income thereunder

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In brief

In a recent decision,[1] of the Kolkata bench of the Income Tax Appellate Tribunal (Tribunal) held that the provisions of section 56(2)(viib) of the Income-tax Act, 1961 (the Act) applies to issue of all classes of shares including redeemable preference shares. Further, it also rules that the tax officer (TO) was duty bound to examine the valuation report submitted by the taxpayer, evaluate it on the basis of facts and record findings thereon.

In detail

Facts

The taxpayer was engaged in the business of investment and financing and had allotted 2,05,000 0.1% redeemable non-cumulative preference shares (RNCPS), with face value of INR 10 each, at a premium of INR 1,990 per share. The RNCPS were redeemable on expiry of 10 years from the date of allotment at a redemption price of INR 5200 per RNCPS. The RNCPS could be redeemed at any time before that with mutual consent at mutually agreed terms. The RNCPS were valued at INR 2000 per RNCPS as per the valuation report from a chartered accountant obtained under Rule 11UA(c)(c). The valuer had used discounted cash flow method and used a discounting factor of 10%. The RNCPS were partly allotted to a group company and other part was allotted to an independent third party.

The TO accepted the discounted cash flow method used in the valuation report, however, he applied discounting rate of 15% instead of 10%. The TO determined the market value of RNCPS at INR 1285.41 per RNCPS as against INR 2000 and made an addition of INR 146.4 million under section 56(2)(viib) of the Act.

The First Appellate Authority upheld the addition but reduced the quantum of addition by changing the discounting rate of 15% used by the TO to compute the market value of the shares to 12.5% without providing any basis for the same.

Aggrieved, both the Revenue and the taxpayer preferred an appeal before the Tribunal.

Issues before the Tribunal

i. Whether provisions of section 56(2)(viib) are applicable to issue of RNCPS ?

ii. Whether TO could examine the valuation report provided by the valuation expert and modify the value?

[1] ITA No. 513/ Kol/ 2017 and ITA No. 963/ Kol/ 2017

iii. Whether the rate of 10% adopted by the valuer is appropriate on the basis of the facts?

Taxpayer's contentions

- Section 56(2)(viib) was introduced with an objective to deter generation and use of unaccounted money through infusion of funds from shareholders at substantial premium. RNCPS are *quasi* debt instruments and not shares per se, and hence, these RNCPS are not covered by the provisions of section 56(2)(viib) of the Act, which was introduced to deal with equity shares.
- Section 56(2)(viib) read with applicable rules require that the valuation of RNCPS should have been supported by report of an expert. The TO was not an expert in the matter of valuation, and hence, could not interfere and tamper with the fair market value determined by the valuer. In case TO was not in agreement with the valuation, only option available to him was to refer the matter to an expert.
- There was no question of liquidity crunch. The taxpayer had readily sellable investment in equity shares and the market value of those equity shares was very high as compared to the value of the RNCPS. The finding of the TO was not based on facts but merely on presumptions.
- The discounting rate of 15%, based on home loan rates, was not appropriate because the investors had no chance of investing in housing loans, as they were regulated by the authorities.
- The rate of return on RNCPS ought to have been higher than the post-tax return on debt instruments which was prevailing at about 8.78% and RNCPS also gives the similar return.
- The TO had ignored the prevailing rate of return on preference shares of other companies that ranged from 8-10%.

Revenue's contentions

- Section 56(2)(viib) of the Act uses the word "shares," and hence, was applicable to RNCPS.
- The TO had the right and was duty bound to examine whether the valuer had based his valuation on relevant material and whether the valuation was properly done and assessed on all aspects which had a bearing on income of the taxpayer. Further, there was no provision in law to refer the valuation of shares to another expert by the TO for valuation.
- The assumptions made by the valuer was not based on the facts. The taxpayer's profit had dipped over the years. The taxpayer would not have an assured and ascertainable cash flow in the future which was likely to lead to liquidity crunch to the taxpayer.
- The burden of tax on dividend in the hands of the taxpayer was minimal, therefore, tax was not a factor to be considered while determining the discounting rate. As it is hardly any dividend was declared. In any case tax rate in the hands of the assessed needs to be considered and not in the hands of the investor.
- Considering that home loan rates were very conservative, as they were given at concessional rates and that too with full security, a discounting rate of 15% was appropriate.

Tribunal's decision

- All classes of shares were covered by section 56(2)(viib) and RNCPS could not be excluded from the ambit of section 56(2)(viib) of the Act.
- The TO could interfere with the valuation report which was not based on relevant material. The TO was duty bound to examine the valuation report and record his findings on the same. Such finding should have been based on relevant material and rational view taken judiciously. It was not necessary for the TO to refer the matter to other expert, TO could replace the irrelevant material and modify the valuation.
- Section 56(2)(viib) which brings notional income to tax is a deeming provision and needs to be strictly interpreted.
- Considering that the taxpayer had a good investment portfolio that had grown in value and could be easily liquidated, the revenue's findings in relation to cash flow crunch was incorrect and was merely based on resumptions.
- The take home return on investment was a crucial factor for an investor to make choice of investment, and hence, tax had to be factored in while determining the net rate of return on investments.
- The rate of return for an investor should have been considered and composed of instruments in which he could deploy his funds. The taxpayer could not have been invested in home loans, and hence, use of home loan rate was highly erroneous and was not to be used.
- The rates of return on preference shares issued by

other companies for the relevant period were relevant for arriving at the discount rate.

Thus, the valuation done by the valuer was based on relevant facts and the rate of 10% discount factor being based on proper comparable, was appropriate, and hence, accepted. Weightage was also given to the fact that an independent investor had invested in RNCPS on the same terms and the fair value was considered to be at arms' length price.

The takeaways

This decision upholds applicability of section 56(2)(viib) to issue of all types of shares and the right of the TO to challenge the valuation report. However, it also confirms that if the valuation is based on appropriate material facts the same need not be disturbed but should be accepted. It also analyses certain facts necessary for valuation and provides insight to application of the same.

Let's talk

For a deeper discussion of how this issue might affect your business, please contact your local PwC advisor

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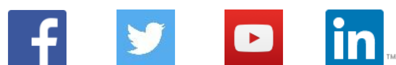

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