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Tax Insights

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An option agreement with a group entity for interim funding is commercially prudent and not a sham transaction – Mumbai bench of the Tribunal

In brief

The Mumbai bench of the Income-tax Appellate Tribunal[1] (Tribunal) allowed an appeal in favour of the taxpayer company, stating that the Revenue cannot step in the shoes of the businessperson and question the commercial expediency of the transaction entered by the taxpayer-company. The Tribunal also held that the price determined under the option agreement can only be determined in accordance with the provisions of sections 50C or 43CA of the Income-tax Act, 1961 (the Act). In addition to the above, with respect to disallowance under section 14A of the Act, the Tribunal held that such disallowance had to be restricted to the extent of exempt income.

In detail

Facts

- The taxpayer-company is engaged in the business of real-estate development, constructing residential and commercial buildings and trading in shares.
- In the financial year (FY) 2009–10, the taxpayer company entered into an option agreement with one of its group entities, whereby the group entity was given an option to purchase 20 flats at a pre-determined price on a future date, against interest-free adjustable option deposits placed with the taxpayer company (Option Agreement).
- The group entity surrendered the options in favour of actual buyers against the option premium and sold such flats to the actual buyers in later years for which a tripartite agreement was entered into between the actual buyer, the taxpayer-company and the group entity.
- During the year under consideration, the taxpayer-company earned dividend income and *suo motu* made disallowance of expenses under section 14A of the Act, to the extent of the exempt income earned.
- According to the Tax Officer (TO), the price fixed in the Option Agreement was on the lower side. The TO, while passing the assessment order, held that such Option Agreement is a sham transaction and was a way to divert part of the sales consideration and the profits from the books of the taxpayer-company to the group

[1] ITA Nos. 1970/Mum/2021 and 2218/Mum/2021

entity. Accordingly, while passing the order, the TO included the entire sales consideration received by the group entity in the hands of the taxpayer-company for the assessment year 2018–19 i.e. FY 2017–18.

The TO, invoking the provisions of rule 8D(2)(iii) of the Income-tax Rules, 1962 (Rules), made an additional disallowance.

- According to the Commissioner of Income-tax (Appeals) [CIT(A)] the Option Agreement undertaken by the taxpayer-company was acceptable and not a sham transaction. However, the CIT(A) benchmarked the option price entered between the taxpayer-company and the group entity based on the price at which the group entity assigned the option to buy one of the flats to a third party in FY 2010–11 and reduced the income of the taxpayer-company.

  With respect to the disallowance under section 14A of the Act, the CIT(A) allowed the appeal in favour of the taxpayer-company.

Tribunal's ruling

Based on the following observations, the Tribunal held that the Option Agreement entered between the taxpayer-company and its group entity was commercially expedient and acceptable and that it was not a sham transaction.

- The group entity was a financial investor, who had participated by contributing capital in the form of interest-free adjustable security deposit and thereby obtained the right over the 20 flats. This was noted to be a business transaction.
- The option price agreed in 2010 was commensurate with the prevailing market value for stamp duty purposes. Hence, it was not given to a related party at an understated value.
- It is the taxpayer's prerogative to decide the manner in which it wants to run its business, and the Revenue cannot replace the wisdom of the taxpayer. It is well settled in law that the Revenue cannot step in the shoes of the businessman for determining reasonableness and business expediency.
- The correct approach to determine the reasonableness of the option price should be based on the market conditions, facts and circumstances in the year of the entering into such an Option Agreement, i.e. in 2010 as against benchmarking the arm's length price of the options to the actual sale consideration or value achieved in later years.
- The group entity and the taxpayer company are both assessed in the status of 'company' at the same applicable tax rates.

With respect to the disallowance under section 14A of the Act, the Tribunal upheld the position of the CIT(A) that the disallowance under section 14A of the Act was to be restricted to the extent of exempt income.

The takeaways

- An option agreement undertaken with group entity for business purposes is not a sham transaction.
- It is a well settled law that the TO cannot step in the shoes of the taxpayer or question the reasonableness and business expediency of a transaction.
- The fair value of the option agreement can be determined only in accordance with the provisions of sections 50C or 43CA of the Act, as the case may be.

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