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Share allotment at premium by a newly incorporated Company is neither sham nor income

In brief

In the recent case of Green Infra Ltd.¹ (the assessee), the Mumbai Income-tax Appellate Tribunal (Tribunal) held that the share allotment at premium by a newly incorporated company cannot be taxed as income invoking section 56(1) of the Income tax Act (Act). Furthermore, if the genuineness and identity of the depositor is established and the transaction was carried out through banking channels, the transaction cannot be taxed under section 68 of the Act.

The case relates to a matter before the introduction of section 56(2)(viib) of the Act.

Facts

- The assessee was incorporated on 3 April 2008 and was subject to regular assessment proceedings for the Financial Year 08-09.
- Of the total investment of INR 489.50 million (mn), the Assessing Officer (AO) observed that INR 479.70 mn was received by the assessee as share premium on the allotment of shares having a face value of INR 10 each at a premium of INR 490.
- The assessee filed an internal valuation report using the discounted cash flow method (DCF) and other relevant documents related to the determination of the value of the shares, which had been obtained before the issue of the shares.

¹ Green Infra Ltd. v. ITO [TS-420-ITAT-2013(Mum)]

- The AO stated that the company had paid-up capital of INR 0.50 mn on incorporation, and hence there was no valid basis justifying the valuation of shares.
- Furthermore, the AO questioned the application of funds collected *via* share premium being invested in units, shares of subsidiary companies and bank FDRs, which according to the AO were in violation of Section 78 of the Companies Act, 1956 (Companies Act).
- The AO held that receipt from the shareholders and share premium received is taxable under the head *income from other sources* under section 56(1) of the Act.
- The Commissioner of Income-tax (Appeals) upheld the AO's order, stating that assessee failed to substantiate the genuineness of the share premium received and that section 56(1) of the Act was wide enough to cover all cases of residuary nature not falling under sections 4 and 5 of the Act.

Issues

- Whether share allotment at premium for newly incorporated company can be taxed as income?
- Whether the transaction can be considered as sham on the grounds that it lacks commercial substance?

Revenue's contentions

- There is no underlying data validating the estimates or projection made by the assessee for the purpose of preparation of the valuation report. Furthermore, the actual values were significantly different from the projected values used for valuation report. The assessee relied on an unauthenticated power sector report and adopted the DCF method, which itself was unrealistic and based on a vague projection without any supporting evidence.
- The assessee does not have any intangible asset such as patents, copyrights, intellectual property rights or even investments which would command a premium at the time of allotment of fresh shares.

- The assessee has failed to utilize the share premium received under section 78 of the Companies Act, and thereby transaction lost the character of capital receipt and had to be treated as residuary receipt, taxed as income under section 56(1) of the Act.
- The AO relied on the Supreme Court decision in McDowell and Co, Ltd.², where it was held that a colourable device could not be part of tax planning.
- Furthermore, the AO relied on decisions of High Courts in the cases of Ramdeo Samadhi³, Smt. Shanthi Meattle⁴, K. Thangamani⁵ and Mogul Line Ltd.⁶ to substantiate that the matter of taxability is independent of accounting treatment done by the assessee in its books.
- The department representative during the proceedings before the Tribunal raised an additional contention of taxing the premium as sham, since the nature of transaction has been questioned by revenue authorities.

Assessee's contentions

- The assessee submitted that issuing shares at a premium was a commercial decision and did not require justification under any law currently in force.
- The assessee further submitted that the premium was a capital receipt required to be dealt with under section 78 of the Companies Act.
- Share premium by its very nature is a capital receipt. Furthermore, the assessee relied on the decision by the Supreme Court in the case of Allahabad Bank Ltd.⁷, where it was held that share premium account had to be included in the paid up capital account irrespective of whether the share premium had been maintained in a separate account apart from the reserve.

² McDowell and Commercial Tax Officer (1985) 154 ITR 148 (SC)

³ Commissioner of Income Tax v. Ramdeo Samadhi (1986) 160 ITR 179 (RAJ)

⁴ Commissioner of Income Tax v. Smt. Shanti Meattle (1973) 90 ITR 385 (ALL)

⁵ Commissioner of Income Tax v. K. Thangamani (2009) 309 ITR 15 (MAD)

⁶ Commissioner of Income Tax v. Mogul Line Ltd. (1962) 46 ITR 590 (BOM)

⁷ Commissioner of Income Tax v. Allahabad Bank Ltd. (1969) 73 ITR 745 (SC)

- Furthermore, the assessee relied on the Supreme Court decision in the case of Standard Vaccum Oil Co.⁸ where it had been held that premium realized from the issue of its shares represented reserve not includible in computing the profits of the company for the purpose of Indian Income-tax Act, 1922. In addition to above, the assessee relied on High Court decisions in the cases of Om Oils & Seeds Exchange Ltd.⁹ and Krishnaram Baldeo Bank (P.) Ltd.¹⁰, where it had been held that share premium was not a revenue receipt.
- The Central Board of Direct Taxes has notified that the fair market value of unquoted equity shares is to be determined by a merchant banker or an accountant as per the discounted free cash flow method.
- The shareholders of the company are under the direct control of the Government of India, therefore it cannot be said that the transaction is sham.

Tribunal Ruling

- It is the prerogative of the Board of Directors of a company to decide the premium amount and it is the wisdom of the shareholders whether they want to subscribe to shares at such a premium or not.
- In the absence of any restriction from any law in force, the revenue cannot question the charging of premium.
- Any receipt can be taxable under section 56(1) of the Act only if it has some character of income.
- The assessee-company had invested funds to set up three subsidiaries as special purpose vehicles for generating wind energy. Hence, the revenue's contention that share premium was not utilized for the purpose for which it was received is incorrect.

- Relying on the Supreme Court decision in the case of Standard Vaccum Oil Co.¹¹ the Tribunal held that share premium is in the nature of capital.
- Furthermore, the Tribunal relied on the decisions of Supreme Court in the cases of Punjab State Industrial Corporation Ltd.¹² and Brooke Bond India Ltd.¹³, where it had been held that expenditure incurred on issuing shares to increase share capital by a company were capital in nature.
- The shareholders in all the related transaction under issue are directly or indirectly related to the Government of India and identity of the shareholders had been established beyond all reasonable doubts. The revenue authorities had not questioned the identity of the shareholders either. Furthermore, the entire transaction had been done through banking channels and hence section 68 of the Act was not applicable.

Conclusion

Heavy premium paid for shares of a newly incorporated company could not be taxed as income, being capital in nature. Further, where the genuineness of shareholders and depositors was established, it could not be held to be a sham transaction.

It is to be noted that this decision is in relation to a transaction before the introduction of section 56(2)(viib) of the Act, which states that if any closely held company issues share to a resident person for a consideration higher than the fair market value (FMV) of such shares, then the difference between the FMV and the consideration shall be considered as income in the hands of such company. Furthermore, DCF is prescribed as one of the methods for valuation of unquoted equity shares under the Act.

The above ruling will be helpful in those cases where the premium on shares issued by the company is questioned as sham by the revenue.

⁸ Commissioner of Income Tax v. Standard Vaccum Oil Co. (1966) 59 ITR 685 (SC)

⁹ Assistant Commissioner of Income Tax v. Om Oils & Seeds Exchange Ltd. (1985) 152 ITR 552 (DELHI)

¹⁰ Commissioner of Income Tax v. Krishnaram Baldeo Bank (P.) Ltd. (1980) 144 ITR 600 (MP)

¹¹ Commissioner of Income Tax v. Standard Vaccum Oil Co. (1966) 59 ITR 685 (SC)

¹² Punjab State Industrial Corporation Ltd. v. Commissioner of Income Tax (1997) 225 ITR 792 (SC)

¹³ Brooke Bond India Ltd. v. Commissioner of Income Tax (1997) 225 ITR 798 (SC)

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