Widening Taxbase With Inclusion of Share Premium From Non-Residents

Feb 07, 2023

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1. Background

Amidst high expectations from the Government’s last full budget before the 2024 general elections, the Hon’ble Finance Minister presented the Indian Union Budget for the fiscal year 2023-24. The Finance Bill 2023 proposed amendments in the direct tax provisions that laid focus on and has been categorised in the following seven points:

1. Rates of Tax;
2. Socio economic welfare measures;
3. Ease of compliance;
4. Widening and deepening of tax base/anti-avoidance;
5. Improving compliance and tax administration,
6. Rationalisation of provisions; and
7. Others.

Amongst the above focus points and as a part of the measure to widen and deepen the tax base and curb tax avoidance, the Finance Bill has proposed an amendment under section 56(2)(viib) of the Income-tax Act, 1961 (the ‘Act’) that has been discussed in the ensuing paragraphs:

2. Existing provisions of section 56(2)(viib) of the Act

The existing provisions of section 56(2)(viib) of the Act provides that any consideration for issue of shares received by a company, not being the company in which public are substantially interested (hereinafter referred to as ‘closely held company’), from any resident shareholder, that exceeds the face value of such shares then, the consideration in excess of the prescribed Fair Market Value (FMV) would be taxable as income in the hands of such closely held company under the head ‘Income from Other Sources’. Further, for the purpose of determining the FMV of share, valuation mechanism has been prescribed under Rule 11UA of the Income-tax Rules, 1962 (the ‘Rules’). These provisions were enacted by Finance Act 2012 as a measure to prevent generation and circulation of unaccounted money and were applicable only in case of receipt of consideration from resident shareholders towards issue of shares.

For an instance, a closely held Indian Company issues shares at INR 100 (having face value of INR 10 per share) and if the FMV of such shares (as computed under Rule 11UA of Rules) is at INR 80 per share then, in such a scenario, as the consideration of INR 100 per share exceeds the face value of share of INR 10, the excess amount received over the FMV of share of INR 20 (i.e. difference between issue price and FMV, (100-80) shall be chargeable to tax as income under section 56(2)(viib) of the Act in the hands of such closely held Indian Company.

3. Budget Proposal

The Finance Bill proposes to include receipt of share consideration exceeding FMV from any non-resident shareholder as well within the ambit of section 56(2)(viib) of the Act; thereby broadening the tax base, irrespective of residential status of the shareholder or share subscriber. Further, the valuation mechanism as prescribed under Rule 11UA of the Rules shall accordingly be made applicable in case of issue of shares to non-resident shareholder.

This amendment will be effective from the fiscal year 2023-24 and shall accordingly apply in relation to the Assessment Year 2024-25 and subsequent assessment years.

With the proposed amendment, several rulings[2] categorically holding non-applicability of provisions of section 56(2)(viib) of the Act in case of the issue of shares to non-resident shareholders would now be put to rest.

In view of the above proposal, some of the key issues that requires considerations have been summarised as under:

4. Interplay between provisions of sections 68 and 56(2)(viib) of the Act

The provisions of section 68 of the Act is an anti-avoidance measure requiring a taxpayer to furnish satisfactory explanations about the nature and source of any sum found credited in its books of account of the taxpayer on being requested by the Tax Authorities.

Accordingly, where a taxpayer fails to provide satisfactory explanation on the nature and source of any sum credited in its books, the whole of such sum so credited would be considered as an income of the recipient company. Additionally, as per the provisions of section 115BBE of the Act, tax payable on such cash credit shall be taxable at the rate of 60% on gross basis (without any deduction of expenses or set-off of losses) which shall be further increased with surcharge of 25% and Health & Education Cess of 4% (effective tax rate of 78%) and penalty of 10% of tax payable under section 115BBE which is in accordance with section 271AAC of the Act.

In view of the above provisions, it is pertinent to note that **the Hon’ble Supreme Court** in the case of NRA Iron & Steel (P.) Ltd[3] has held that the provisions of section 68 of the Act are widely worded to include within its ambit, investments made by way of share capital or share premium. Further, various judicial precedents[4] have consistently and categorically held that where the share issuing company failed to prove genuineness of the transaction of receipt of share consideration (i.e. not able to furnish proof of identity and creditworthiness of the payer / shareholder), the receipt of whole sum was found as cash credit being an income of the company and accordingly subject to tax under section 68 of the Act.

Therefore, now, even after share premium in excess of FMV being specifically subject to tax under section 56(2)(viib) of the Act, the question that requires consideration is whether the requirement of the recipient company to prove genuineness of the share issue transaction and furnish nature and source of sum received to the satisfaction of the Tax Authorities (if called for) would still apply for the purpose of section 68 of the Act.

On the application of the sections 68 and 56(2)(viib) of the Act, the Tax Authorities may contend that both anti-avoidance measures are being introduced with different objectives. Further, none of these provisions override the other. Also, there are exclusions under each of these provisions. Therefore, both these provisions can co-exist. This contention has been further upheld by the **Hon'ble Kerala High Court** in the case of **Sunrise Academy of Medical Specialities (India) (P.) Ltd.**[5]

Further, in order to understand the implication of co-existence of the provisions of section 56(2)(viib) and section 68 of the Act, we have further extended the illustration discussed above wherein INR 20 was chargeable to tax as income under section 56(2)(viib) of the Act in the hands of company.

Assuming the number of shares issued to a non-resident shareholder is 10,000, income chargeable under section 56(2)(viib) of the Act in the hands of share issuing company would amount to INR 200,000 and consequent tax liability (based on maximum rate) on the said income could be upto INR 70,000 (200,000 x 34.944%).*

However, upon being requested by the Tax Authorities, if the said Indian company fails to provide satisfactory explanations regarding nature and source of share consideration received then, the whole sum of consideration so received shall be taxed at INR 156,000 (200,000 x 78%) (excluding penalty exposure, if any).

Accordingly, the total tax liability on the same transaction in the hands of the share issuing company would be INR 226,000.

However, where the share consideration exceeding FMV is subjected to tax under section 56(2)(viib) of the Act and further Tax Authorities are not satisfied with the explanation of the company in respect of nature and source of the consideration received for issue of shares and therefore proceeds to invoke provisions of section 68 of the Act, in such a case, it would tantamount to double taxation of income which has been already subjected to tax under section 56(2)(viib) of the Act.

Therefore, in order to avoid such double taxation situation and to avoid litigation on this aspect, it is sought that the Finance Bill 2023 provides necessary relief by providing mutual exclusivity to these two provisions from its application (such as the proposed provisions of section 56(2)(viib) of the Act should not be applicable in case provisions of section 68 is attracted, etc.).

5. Interplay between provisions of section 56(2)(viib) and Transfer Pricing Provisions

Transfer Pricing provisions being specific anti-avoidance provisions are enshrined under Chapter X of the Act that inter-alia, provides for taxability of income in respect of international transactions to be computed having regard to arm's length price.

In this regard, the provisions of section 92(1) of the Act, being the charging provision, very clearly enunciate to cover within its ambit, 'any income' arising from an international transaction as defined under the Act. Accordingly, the basic condition that ought to be satisfied for the applicability of transfer pricing provisions is 'presence of income' from any international transaction.

The term 'income' has been defined under section 2 of the Act in an inclusive manner to inter-alia include under clause (24)(xvi), '*any receipt of share consideration in excess of fair market value under section 56(2)(viib) of the Act*'. Since the provisions of section 56(2)(viib) of the Act were not applicable to non-resident shareholders earlier, any share consideration received from them fell outside the ambit of the definition of 'income' under section 2 of the Act.

The aforesaid principle was also upheld by the **Hon'ble Bombay High Court** in the case of **Vodafone India Services (P.) Ltd**[6] and in other rulings[7] wherein it has been pronounced that transfer pricing provisions, specifically section 92 of the Act shall also not apply on the transaction of receipt of share premium from non-residents in the absence on 'income' element in the transaction that is a condition precedent for applicability of section 92 of the Act.

Hence, earlier, the receipt of excess share consideration by a closely held company from a non-resident was categorically excluded from applicability of transfer pricing provisions.

However, after the proposed amendment, the transfer pricing provisions would consequently be applicable to the closely held company on receipt of excess share consideration from non-resident shareholders in accordance with section 92(1) read with section 2(24)(xvi) of the Act.

6. Interplay between provisions under the Act and FEMA

Apart from being mindful about the implications under the Act, closely held companies seeking funding from non-residents should also consider direct/indirect implications under other laws in India. One such example would be that of interplay with the Foreign Exchange Management Act, 1999 ('FEMA') for which a few intermingling challenges are discussed as under:

- Valuation date under the Act is prescribed to be the date of receipt of share consideration. Whereas under FEMA, the valuation needs to be undertaken at the time of issuance of shares.
- Valuation norms under FEMA mandates the closely held company to issue shares to non-residents atleast at a floor price i.e. value higher than or equal to the FMV. Whereas, the Act seeks to tax any share consideration received in excess of FMV in the hands of closely held company. The said contrast would effectively bind the closely held company to issue shares to non-resident exactly at FMV to satisfy compliance and avoid adverse consequence under both the laws.
- Valuation Methodology to arrive at FMV of shares also differs under both the laws. Where, the Act prescribes one of the two methods namely Discounted Free Cash Flow (DCF) method and Net Asset Value (NAV) method, FEMA prescribes any internationally accepted pricing methodology.

Hence, it would be imperative for the closely held company to carefully deliberate and cautiously tread further to avoid any unfavourable consequences under Act or any other laws.

7. Concluding Thoughts:

Initially, non-residents shareholders investing in shares of closely held companies were specifically excluded from the purview of taxability under section 56(2)(viib) of the Act with a view to encourage foreign investments. However, with India witnessing astounding growth in FDI equity inflows from INR 1219 bn in FY 2012-13 to INR 4372 bn in FY 2021-22 and in order to over-turn several judicial precedents wherein provisions of section 56(2)(viib) of the Act were not made applicable to foreign investors, the Government is now looking forward to widen the tax base to include share premium received in excess of FMV from non-resident shareholders as well.

However, it is pertinent to note that most of the anti-avoidance measures enshrined under the Act have provided some relaxations to certain taxpayers by either prescribing a tolerance band such as provisions of section 50C of the Act, safe harbour rules, etc. or an acceptable threshold i.e. general anti-avoidance rules, business connection by way of significant economic presence, etc. or range concept from transfer pricing perspective. However, the anti-abuse provisions under section 56(2)(viib) of the Act requiring the closely held company to undertake compliances would apply without having regard to the materiality of the share issue or excess share issue consideration.

Expanding the scope of section 56(2)(viib) of the Act has technically brought in uninvited challenges for the closely held company to also undertake other compliances. Further, the burning and ongoing litigation around determination of year of taxability (i.e. year of receipt of consideration vs date of share allotment) of excess share consideration based on conflicting rulings and several controversies around basis and acceptability of method of valuation adopted by the closely held company would now drag in non-resident shareholders as well, further aggravating the said issues and therefore clarifications in this regard would be the need of the hour.

* *Consequent tax liability (based on maximum rate) on the income chargeable under section 56(2)(viib) of the Act in the hands of share issuing company would be upto INR 50,500 (25.168%) in case of certain domestic companies in accordance with section 115BAA of the Act and upto INR 34,500 (17.16%) in case of new manufacturing domestic companies in accordance with section 115BAB of the Act.*

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[1] The views expressed in this article are personal views of the authors and does not resemble any professional advice.

[2] Raw Pressery (P.) Ltd. v. ACIT [TS-689-ITAT-2022(Mum)], Milk Mantra Dairy (P.) Ltd. v. DCIT [TS-525-ITAT-2022(Kol)], Ruchi J Oil (P.) Ltd. v. PCIT [TS-233-ITAT-2021(Ind)], DCIT v. Finproject India (P.) Ltd. [TS-232-ITAT-2018(Mum)]

[3] PCIT v. NRA Iron & Steel (P.) Ltd[3] [TS-106-SC-2019]

[4] PCIT v. SRM Systems and Software (P.) Ltd [TS-6966-HC-2021(Madras)-O]; Pratik Syntex (P.) Ltd. v. ITO [TS-6965-ITAT-2018(Mumbai)-O]; Ayaana Comtrade (P.) Ltd. v. ITO [TS-6047-ITAT-2019(Ahmedabad)-O]; M.A. Projects (P.) Ltd. v. DCIT [TS-7125-ITAT-2019(Delhi)-O];

[5] Sunrise Academy of Medical Specialities (India) (P.) Ltd. v. ITO [TS-434-HC-2018(KER)]

[6] Vodafone India Services (P.) Ltd v. Union of India [TS-5904-HC-2014(Bombay)-O]

[7] S.G. Asia Holdings (India) (P.) Ltd. v. DCIT [TS-6004-HC-2014(Bombay)-O]; SKR BPO Services (P.) Ltd. v ITO [TS-5095-HC-2015(Bombay)-O]; Equinox Business Parks (P.) Ltd. v. UOI [TS-6002-HC-2014(Bombay)-O]; Essar Projects (India) Ltd. v. UOI [TS-6001-HC-2014(Bombay)-O]; Vodafone India Services (P.) Ltd. v. UOI [TS-655-ITAT-2014(Mum)-O]; Shell India Markets (P.) Ltd. v. ACIT [TS-6000-HC-2014(Bombay)-O].