

INCOME TAX APPELLATE TRIBUNAL BAR ASSOCIATION, NEW DELHI

Interpretation of Section 56 & Implications

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Contents

1. Interpretation of S. 56(2)(viib) – Purposive or Literal
2. Onus of AO or Assessee to trigger S. 56(2)(viib)
3. Interplay of S. 68 v. 56(2)(viib)
4. Scope of the assessing officer in accepting or rejecting the Valuation Report or reference to Valuation Officer
5. Dichotomy in the Valuation Rules for 56(2)(viib) and 56(2)(x)

1. Interpretation

Issue of Shares – Application of S.56(2)(viib)

- (i) Issue of shares at same price to resident and non-resident
- (ii) Section 56(2)(viib) is not applicable when money is received by a resident from a non-resident, however it gets attracted (if read literally) when the resident further invests same money into another resident ? Such situations are not hard to examine as normally FDI first comes into main India Holding Company and then that very money is further invested in group subsidiaries.
- (iii) X avails loan of Rs 100 from bank and invests it further in shares of Rs 10 with premium of Rs 90.
- (iv) A and B (husband and wife) are existing share-holders with 60:40 ratio. Both invest further in company by acquiring fresh equity at huge premium however the share holding ratio remains same.
- (v) Bonafide investment in shares of a start-up company, which is running into losses and the valuation cannot be defended with DCF but is supported with market justifications.

EXPLANATORY NOTES TO FINANCE ACT (NO.2), 2004

Modification of the definition of income to include any sum of money exceeding twenty-five thousand rupees received without consideration

In order to curb bogus capital building and money lending, a new sub-section has been inserted in Section 56 to provide that any sum received without consideration on or after First day of September 2004, by an individual or HUF from any person shall be treated as income from other sources. A threshold limit of twenty-five thousand rupees is also provided. If the amount so received exceeds this limit, the whole of the amount shall become taxable.

In order to avoid hardship in genuine cases, certain sums have been excluded. The sums which shall not be included in the income are: (a) the sums received (i) from any relative, or (ii) on the occasion of the marriage of the individual; or (iii) under a will or by way of inheritance; or (iv) in contemplation of death of the payer. The expression 'relative' has also been defined for the purpose of this clause.

Section 2 has also been amended to provide that 'income' defined in clause (24) shall also include the income referred to in the new sub-clause (v) of clause (2) of section 56.

This amendment has taken effect from 1st April 2005, and applied in relation of assessment year 2005-06 and subsequent assessment years.

24. Taxation of certain transactions without consideration or for an inadequate consideration as income from other sources

- 24.1** The previous provisions of sub clause (vi) of section 56 provided that any 'sum of money' (in excess of the prescribed limit of rupees fifty thousand) received without consideration by an individual or HUF would be chargeable to income tax in the hands of the recipient under the head 'income from other sources'. However, receipts from relatives or on the occasion of marriage or under a will were outside the scope of the provisions of clause (vi) of sub-section (2) of section 56 of the Income-tax Act. Similarly, anything which is received in kind having 'money's worth' i.e. property were also remained outside the purview of these provisions.
- 24.2** The above **section being an anti-abuse measure**, in view of the above, section 56 of the Income-tax Act, 1961 has been amended by inserting a new clause (vii) in sub-section (2) to provide that the value of any property received without consideration or for an inadequate consideration will also be included in the computation of total income of the recipient as income from other source.

MEMORANDUM TO FINANCE ACT, 2010

13. Taxation of certain transactions without consideration or for inadequate consideration

13.1 Under the previously existing provisions of section 56(2)(vii), any sum of money or any property in kind which is received without consideration or for inadequate consideration (in excess of the prescribed limit of Rs. 50,000/-) by an individual or an HUF is chargeable to income tax in the hands of recipient under the head 'income from other sources'. However, receipts from relatives or on the occasion of marriage or under a will are outside the scope of this provision. The existing definition of property for the purposes of section 56(2)(vii) includes immovable property being land or building or both, shares and securities, jewellery, archeological collection, drawings, paintings, sculpture or any work of art.

13.2 These are anti-abuse provisions which are currently applicable only if an individual or an HUF is the recipient. Therefore, transfer of shares of a company to a firm or a company, instead of an individual or an HUF, without consideration or

at a price lower than the fair market value does not attract the anti-abuse provision. In order to prevent the practice of transferring unlisted shares at prices much below their fair market value, it is proposed to amend section 56 to also include within its ambit transactions undertaken in shares of a company (not being a company in which public are substantially interested) either for inadequate consideration or without consideration where the recipient is a firm or a company (not being a company in which public are substantially interested). Section 2(18) provides the definition of a company in which the public are substantially interested. It is also proposed to exclude the transactions undertaken for business reorganization, amalgamation and demerger which are not regarded as transfer under clauses (via), (vic), (vicb), (vid) and (vii) of section 47 of the Act.

13.3 Applicability – This amendment has been made effective from 1st June, 2010 and accordingly apply in relation to assessment year 2011-12 and subsequent assessment years.

13.4 The provisions of section 56(2)(vii) were introduced as a counter evasion mechanism to prevent laundering of unaccounted income under the garb of gifts, particularly after abolition of the Gift Tax Act. The provisions were intended to extend the tax net to such transactions in kind. The intent is not to tax the transactions entered into in the normal course of business or

trade, the profits of which are taxable under specific head of income. It is, therefore, proposed to amend the definition of property so as to provide that section 56(2)(vii) will have application to the 'property' which is in the nature of a capital asset of the recipient and therefore would not apply to stock-in-trade, raw material and consumable stores of any business of such recipient.

- 13.5** In several cases of immovable property transactions, there is a time gap between the booking of a property and the receipt of such property on registration, which results in a taxable differential. It is, therefore, proposed to amend clause (vii) of section 56(2) so as to provide that it would apply only if the immovable property is received without any consideration and to remove the stipulation regarding transactions involving cases of inadequate consideration in respect of immovable property.
- 13.6** Applicability - These amendments are proposed to take effect retrospectively from 1st October, 2009 and will, accordingly, apply in relation to the assessment year 2010-11 and subsequent years.
- 13.7** The definition of 'property' as provided under section 56 has been amended to include transactions in respect of 'bullion'. This amendment is proposed to take effect from 1st June, 2010 and will, accordingly, apply in relation to the assessment year 2011-12 and subsequent years.

SPEECH OF FINANCE MINISTER (BUDGET 2012)

155. I propose a series of measures to deter the generation and use of unaccounted money. To this end, I propose

- Introduction of compulsory reporting requirement in case of assets held abroad.
- Allowing for reopening of assessment upto 16 years in relation to assets held abroad.
- Tax collection at source on purchase in cash of bullion or jewellery in excess of ` 2 lakh.
- Tax deduction at source on transfer of immovable property (other than agricultural land) above a specified threshold.
- Tax collection at source on trading in coal, lignite and iron ore.
- Increasing the onus of proof on closely held companies for funds received from shareholders as well as taxing share premium in excess of fair market value.
- Taxation of unexplained money, credits, investments, expenditures etc., at the highest rate of 30 per cent irrespective of the slab of income.

SPEECH OF FINANCE MINISTER (BUDGET 2017)

1. Additional Revenue Mobilisation (ARM) and Anti-abuse Measures

1.1

1.2 It is proposed to widen the scope of section 56 of the Income-tax Act to provide that any money, immovable property or specified movable property received without consideration or with inadequate consideration, by any person, subject to certain exemption and exceptions, shall be taxable if its value exceeds rupees fifty thousand.

SECTION 56 – INCOME FROM OTHER SOURCES.

(1) Income of every kind which is not to be excluded from the total income under this Act shall be chargeable to income-tax under the head "Income from other sources", if it is not chargeable to income-tax under any of the heads specified in section 14, items A to E.

(2) In particular, and without prejudice to the generality of the provisions of subsection (1), the following incomes, shall be chargeable to income-tax under the head "Income from other sources", namely :—

- (i) ...
- (ii) ...
- (iii) ...
- (iv) ...
- (v) ...
- (vi) ...
- (vii) ...
- (viiia) ...

(viiib) where a company, not being a company in which the public are substantially interested, receives, in any previous year, from any person being a resident, any consideration for issue of shares that exceeds the face value of such shares, the aggregate consideration received for such shares as exceeds the fair market value of the shares:

Principles of Interpretation

Heydon's Rule

- It is not really correct to say that the rule in Heyden's case is not applicable when the language is not ambiguous
- The correct principle is that after the words have been construed in their context and it is found that the language is capable of bearing only one construction, the rule in Heyden's case ceases to be controlling and gives way to the plain rule.
- Girdhari Lal vs Balbir Nath Mathur: AIR 1986 SC 1499 Held –
“Even where the words of statutes appear to be prima facie clear and unambiguous it may some times be possible that the plain meaning of the words does not convey and may even defeat the intention of the legislature; in such cases there is no reason why the true intention of the legislature, if it can be determined, clearly by other means, should not be given effect. Words are meant to serve and not to govern and we are not to add the tyranny of words to the other tyrannies of the world.....”

Principles of Interpretation

8. *Once Parliamentary intention is ascertained and the object and purpose of the legislation is known, it then becomes the duty of the court to give the statute a purposeful or a functional interpretation, this is what is meant when, for example, it is said that measures aimed at social amelioration should receive liberal or beneficent construction. Again, the words of a statute may not be designed to meet the several un contemplated forensic situations that may arise. **The draftsman may have designed his words to meet what Lord Simon of Glaisdale calls the 'primary situation'. It will then become necessary for the court to impute an intention to Parliament in regard to 'secondary situations'. Such 'secondary intention' may be imputed in relation to a secondary situation so as to best serve the same purpose as the primary statutory intention does in relation to a primary situation.***

9. *So we see that the primary and foremost task of a court in interpreting a statute is to ascertain the intention of the legislature, actual or imputed. Having ascertained the intention, the court must then strive to so interpret the statute as to promote or advance the object and purpose of the enactment. For this purpose, where necessary the court may even depart from the rule that plain words should be interpreted according to their plain meaning. There need be no neck and mute submission to the plainness of the language. To avoid patent injustice, anomaly or absurdity or to avoid invalidation of a law, the court would be well justified in departing from the so-called golden rule of construction so as to give effect to the object and purpose of the enactment by supplementing, the written word if necessary."*

Principles of Interpretation

- Again in case of *Eera vs State* (Govt of Delhi) reported in (2017) 15 SCC 133 Apex Court has echoed and clarified the above understanding.
- Court propounded the theory of Creative Interpretation following Heydon's Rule and demarcated a *Laxman Rekha* for this purpose.
- Apex Court also referred to Maxwell on Interpretation of Statutes, Tenth Edn. to quote as under:

“Where the language of a statute, in its ordinary meaning and grammatical construction, leads to a manifest contradiction of the apparent purpose of the enactment, or to some inconvenience or absurdity, hardship or injustice, presumably not intended, a construction may be put upon it which modifies the meaning of the words, and even the structure of the sentence. ... Where the main object and intention of a statute are clear, it must not be reduced to a nullity by the draftsman's unskilfulness or ignorance of the law, except in a case of necessity, or the absolute intractability of the language used.”

Principles of Interpretation

- Noted that modern Trend in Commonwealth Countries have recognised the need to examine text as well as context and object or purpose as well as literal meaning and concluded (in para 113) as under:

*“113. It is thus clear on a reading of English, U.S., Australian and our own Supreme Court judgments that the 'Lakshman Rekha' has in fact been extended **to move away from the strictly literal Rule of interpretation back to the Rule of the old English case of Heydon, where the Court must have recourse to the purpose, object, text, and context of a particular provision before arriving at a judicial result. In fact, the wheel has turned full circle. It started out by the Rule as stated in 1584 in Heydon's case, which was then waylaid by the literal interpretation Rule laid down by the Privy Council and the House of Lords in the mid 1800s, and has come back to restate the Rule somewhat in terms of what was most felicitously put over 400 years ago in Heydon's case**”*

Principles of Interpretation

- The above settled legal principals have also been applied by Apex Court in Income Tax Cases. One decision which will have a direct bearing on interpretation of section 56 is the case of KP Vergese reported in 131 ITR 597(SC).

Consideration for transfer in cases of under-statement

Section 52

“

(2) Without prejudice to the provisions of sub-s. (1), if in the opinion of the ITO the fair market value of a capital asset transferred by an assessee as on the date of the transfer exceeds the full value of the consideration declared by the assessee in respect of the transfer of such capital asset by an amount of not less than fifteen per cent of the value so declared, the full value of the consideration for such capital asset shall, with the previous approval of the IAC, be taken to be its fair market value on the date of its transfer."

Deeming Fiction – Principles of Interpretation

K.P. Varghese v. ITO: 131 ITR 597 (SC)

- Revenue intended to give a literal interpretation to above provisions however, this was not accepted by Court as it was resulting in unreasonable and absurdity contrary to intent. Held –

“It is a well-recognised rule of construction that a statutory provision must be so construed, if possible, that absurdity and mischief may be avoided. There are many situations where the construction suggested on behalf of the revenue would lead to a wholly unreasonable result which could never have been intended by the Legislature.....

Can it be contended with any degree of fairness and justice that in such cases, where there is clearly no understatement of consideration in respect of the transfer and the transaction is perfectly honest and bona fide and, in fact, in fulfilment of a contractual obligation, the asses-see who has sold the property should be liable to pay tax on capital gains which have not accrued or arisen to him. It would indeed be most harsh and inequitable to tax the assessee on income which has neither arisen to him nor is received by him, merely because he has carried out the contractual obligation undertaken by him.”

Deeming Fiction – Principles of Interpretation

K.P. Varghese v. ITO: 131 ITR 597 (SC)

“It is now a well-settled rule of construction that where the plain literal interpretation of a statutory provision produces a manifestly absurd and unjust result which could never have been intended by the Legislature, the Court may modify the language used by the Legislature or even 'do some violence' to it, so as to achieve the obvious intention of the Legislature and produce a rational construction - Luke v. Inland Revenue Commissioner [1963] AC 557. The Court may also in such a case read into the statutory provision a condition which, though not expressed, is implicit as constituting the basic assumption underlying the statutory provision.”

- Court applied Heydon’s Rule and looked into object and purpose. It also held that for looking into object and purpose Finance Minister’s speech may also be referred..... para 8 and 11

Section 56(2)(viib) – Deeming Fiction

- Receipt of share capital alongwith share premium is a capital receipt:
 - Vodafone India Services (P.) Ltd. v. Addl. CIT [\[2014\] 368 ITR 1](#)
 - ACIT vs. Om Oils and Oil Seeds Exchange Ltd: 152 ITR 552 (Delhi)
 - Asiatic Oxygen Ltd vs. DCIT: (1994) 49 ITD 355 (Kol)

- Capital receipt does not fall within the nature meaning of word 'income'.

- Finance Act, 2012 made amendment in the definition of 'income' under section 2(24) to specifically include – share premium referred in section 56(2)(viib) as deemed income.

Deeming Fiction - Principles of Interpretation

- Legal fiction are for a definite purpose and they are limited to the purpose for which they are created and should not be extended beyond that legitimate field.
- A construction which defeats the very purpose sought to be achieved by the legislature must be avoided.

Deeming Fiction – Principles of Interpretation

- **K.R. Venkitaperumal Raja vs. CIT: 193 ITR 213 (Kerela)**
 - Best Judgment Assessment made under section 18(4) of Agricultural IT Act.
 - Assessee argued – No valid service of notice of assessment
 - AO argued – No ROI filed by the 'A'; Notice sent by registered post to the last known address of 'A'; Valid service of notice, although post was returned as 'A' not found

Deeming Fiction – Principles of Interpretation

- **K.R. Venkitaperumal Raja vs. CIT: 193 ITR 213 (Kerela)**

- Reliance by AO on section 64, which read as under:

"64. Manner of service of notice—(1) Any notice required to be served on, or given to, any person under this Act or the rules made thereunder shall be deemed to be duly served or given—

.....

(c) if it is sent by registered post to that person at his last known place of residence or business."

Deeming Fiction – Principles of Interpretation

- **K.R. Venkitaperumal Raja vs. CIT: 193 ITR 213 (Kerela)**

“But, it should be remembered that the deeming provisions contained in s. 64(1) of the Kerala Agrl. IT Act or s. 26 of the Interpretation and General Clauses Act, 1125, are only legal fictions.....In Radhakrishna Panchithaya vs. H. Sanjeeva Rao, AIR 1963 Ker 348 ; (1963) KLT 656, Joseph J., delivering the judgment of the Bench, dealt with the scope and relevancy of the legal fiction as follows:..... **Fictions of law hold only in respect of the ends and purposes for which they were invented.** When they are urged to an intent and purpose not within the reason and policy of the fiction, the other party may show the truth’.

Deeming Fiction – Principles of Interpretation

- **K.R. Venkitaperumal Raja vs. CIT: 193 ITR 213 (Kerela)**

8. The legal fiction in s. 64(1) is created only for a definite purpose, namely, for the service of a notice on a person. The service of notice may be done, either by tendering it or serving it on the person concerned or by sending the notice by registered post, at his last known place of residence or business. **The fiction should be limited to the purpose for which it is created. It should not be extended beyond the purpose for which it was created.....** It cannot be said that the sending of the registered notice by post to a person, at his last known place of residence or business, in the circumstances, could be treated as a valid service contemplated by s. 64(1)(c) of the Act.”

Deeming Fiction – Principles of Interpretation

- **CIT v. Shrishakti Trading Co.: 207 ITR 442 (Bom.)**

- Erstwhile section 33 of the Act permitted development rebate on investments in P&M, subject to the conditions that such P&M should not be transferred within 8 years
- One exception to the condition of transfer of assets was – “Where business of the Firm was succeeded by the Company...and all the assets and liabilities of the Firm are taken over by the Company”. Section 155(5) permitted such withdrawal in later year
- In the facts of the present case, all the assets, except cash balance, was transferred. AO held that, the case of ‘A’ did not fall in exception, as all the assets were not transferred, and, therefore, denied rebate u/s 33 read with section 155(5).

Deeming Fiction – Principles of Interpretation

- CIT v. Shrishakti Trading Co.: 207 ITR 442 (Bom.)

Finding

- “Thus, s. 155(5) is a deeming provision which is intended to withdraw the development rebate originally allowed if subsequently the assessee acts in any manner specified therein. It creates a legal fiction that if the assessee does any of the acts specified therein, the development rebate originally allowed shall be deemed to have been wrongly allowed. It is well-settled that legal fictions are for a definite purpose and they are limited to the purpose for which they are created and should not be extended beyond that legitimate field. It is also well-settled rule of interpretation that in construing the scope of legal fiction, it is proper and even necessary to assume all those facts on which alone the fiction can operate. A construction which defeats the very purpose sought to be achieved by the legislature must, if possible, be avoided.”(emphasis supplied)

Deeming Fiction – Principles of Interpretation

Section 2(22)(e) – Deemed Dividend

"Any payment by a company, not being a company in which the public are substantially interested, of any sum (whether as representing a part of the assets of the company or otherwise) made after the 31st day of May, 1986, by way of advance or loan to a shareholder, being a person who is the beneficial owner of shares (not being shares entitled to a fixed rate of dividend whether with or without a right to participate in profits) holding not less than ten per cent of the voting power, or to any concern in which such shareholder is a member or a partner and in which he has a substantial interest (hereafter in this clause referred to as the said concern) or any payment by any such company on behalf, or for the individual benefit, of any such shareholder, to the extent to which the company in either case possesses accumulated profits.

But 'dividend' does not include

(i).....

(ii) any advance or loan made to a shareholder or the said concern by a company **in the ordinary course of its business, where the lending of money is a substantial part of the business of the company.**"

Deeming Fiction – Principles of Interpretation

Section 2(22)(e) – Deemed Dividend

- Circular No. 19/2017, dated 12.6.2017
- CIT v. Raj Kumar: 318 ITR 462 (Del.)
- CIT v. Creative Dyeing & Printing (P) Ltd.: 318 ITR 476 (Del.)
- CIT v. Nagindas M. Kapadia: 177 ITR 393 (Bom.)
- Pradip Kumar Malhotra v. CIT: 338 ITR 538 (Cal.)

“After hearing the learned counsel for the parties and after going through the aforesaid provisions of the Act, we are of the opinion that the phrase "by way of advance or loan" appearing in sub-cl. (e) must be construed to mean those advances or loans which a shareholder enjoys for simply on account of being a person who is the beneficial owner of shares (not being shares entitled to a fixed rate of dividend whether with or without a right to participate in profits) holding not less than ten per cent of the voting power; **but if such loan or advance is given to such shareholder as a consequence of any further consideration which is beneficial to the company received from such a shareholder, in such case, such advance or loan cannot be said to a deemed dividend within the meaning of the Act. Thus, for gratuitous loan or advance given by a company to those classes of shareholders would come within the purview of s. 2(22) but not to the cases where the loan or advance is given in return to an advantage conferred upon the company by such shareholder.**”

Deeming Fiction – Principles of Interpretation

Case Laws dealing with S. 56(2)(viib)

1. Vaani Estate (P) Ltd v. ITO 172 ITD 629(Chennai)
2. ACIT v. Subodh Menon [2019] 175 ITD 449(Mum)
3. DCIT v. Kumar Pappu Singh [2019] 174 ITD 465(Vishaka)
4. Cinestaan Entertainment P. Ltd. vs. ITO: 200 TTJ 459 (Del.)
5. ITO v. Chiropal Poly Films Ltd. (ITA No. 2671/Mum/16)(dated 19/02/19)(ITAT Mum)

Deeming Fiction – Principles of Interpretation

Vaani Estate (P) Ltd v. ITO 172 ITD 629(Chennai)

Assessee subscribed shares of Company on the basis of FMV of shares to be arrived on the basis of land to be procured after infusion of share capital; The other only shareholder was daughter of Assessee – AO computed FMV on the date of allotment and added the difference as income u/s 56(2)(viib). Held –

“7.3 It should be also kept in mind that provisions of Section 56(2)(viib) of the Act creates a deeming fiction and while giving effect to such legal fictions all facts and circumstances incidental thereto and inevitable corollaries thereof have to be assumed.....Further it is apparent from the Finance Minister's speech that the provisions of Section 56(2)(viib) has been enacted to deter the generation and use of unaccounted money..... 7.4 Bearing in mind, the facts of the case, the decision of the higher Judiciary Authorities cited supra and the legal principles discussed herein above, we are of the considered view that provisions of Section 56(2)(viib) of the Act, cannot be invoked in the case of the assessee company because by virtue of cash being brought into the assessee company by Mrs. Sasikala Raghupathy for allotment of equity shares with unrealistic premium the benefit has only passed on to her daughter Mrs. Vani Raghupathy and there is no scope in the Act to tax when cash or asset is transferred by a mother to her daughter.”(emphasis supplied)

Deeming Fiction – Principles of Interpretation

ACIT v. Subodh Menon [2019] 175 ITD 449(Mum)

Director subscribed shares of the Company at Face Value in order to infuse funds at the direction of the lending Bank, while FMV of Company was higher – Addition made by AO u/s 56(2)(vii). Held –

“We further observe that provisions of section 56(2)(vii) does not apply to *bona fide* business transaction. As explained hereinabove, shares were issued by the company to comply with a covenant in the loan agreement with State Bank of India which required the promoters to increase the total net worth of the company to Rs. 150 crores by 31 March, 2010. Therefore, the shares were issued by the company for a *bona fide* reason and as a matter of business exigency. Circular No.1/2011 dated 6 April, 2011 issued by the CBDT explaining the provision of section 56(2)(vii) specifically states that the section was inserted as a counter evasion mechanism to prevent money laundering of unaccounted income. In paragraph 13.4 thereof where it is stated that “the intention was not to tax transactions carried out in the normal course of business or trade, the profit of which are taxable under the specific head of income”.

18. In the instant case, the transaction of issue of shares was carried out to comply with a covenant in the loan agreement with the bank to fund the acquisition of the business by the subsidiary in USA, therefore, such a *bona fide* business transaction cannot be taxed under section 56(2)(vii) of the Act especially when there is not even a whisper about money laundering by the AO in the assessment order.”

Deeming Fiction – Principles of Interpretation

Cinestaan Entertainment P. Ltd. vs. ITO: 200 TTJ 459 (Del.)

Newly incorporated company in the stage of setting up new business issued shares to reputed investors, at premium, after considering potential of Company.

Held -

“Thus, neither the identity nor the creditworthiness of the investors nor the genuineness of the transaction can be doubted and in fact the same stands fully established to which Assessing Officer has also not raised any doubt or disputed this fact. Thus, under the deeming provisions of section 68, the test of proving the nature and source of the credit received stood accepted.....We are in tandem with such a reasoning of the Id. Counsel, because the deeming fiction not only has to be applied strictly but also have to be seen in the context in which such deeming provisions are triggered.....It cannot be the unaccounted or black money of investors as it is their tax paid money invested, duly disclosed and confirmed by them; and nothing has been brought on record that it is unaccounted money of assessee company routed through circuitous channel or any other dubious manner through these accredited investors. If such a strict view is adopted on such investment as have been done by the Assessing Officer and by Id. CIT(A), then no investor in the country will invest in a 'start-up company', because investment can only be lured with the future prospects and projection of these companies.....”

2. Onus of AO/Assessee

Onus of Assessing Officer/Assessee

- Initial Burden is on Assessee to establish bonafide / genuineness of the Transaction.
- The burden gets discharged: (A) – If section 68 invoked by AO, proving tests of that section 68 [If, section 68 applies to any credit hence entire credit will have to be explained], (B) If section 68 not invoked and impliedly accepted by AO, by proving bonafide/commercial expediency of the share issue.
- Once transaction is tested (either explicitly or impliedly) by the tax department and the AO is satisfied that the transaction is a genuine business transaction i.e without any element of tax avoidance then there is no requirement to further test FMV of Share Premium applying provisions of section 56(2)(viib).
- However, where the AO by resort to either material, have inference of other evidence doubting that the transaction may be for tax avoidance then the AO may direct assessee to satisfy FMV of Share Premium as per requirements of section 56(2)(viib).

3. Interplay of S. 68 v. 56(2)(viib)

Interplay – S. 68 v. 56(2)(viib)

- Where all three tests of S.68 not satisfied – Addition to be made u/s 68
- Where the identity and creditworthiness of the creditor accepted, but genuineness/bonafide/commerciality of the transaction is doubted merely because of the amount of premium charged for issue of shares – S. 56(2)(viib) gets triggered.
- Where the assessee satisfies the bonafide behind issue of shares at premium, S 56(2)(viib) cannot be applied, nor the method of valuation prescribed therein
- Where the assessee is not able to satisfy bonafide of the transaction for issue of shares at premium, S. 56(2)(viib) will be attracted and the assessee will need to justify premium with reference to methods of valuation prescribed therein.

Interplay – S. 68 v. 56(2)(viib)

In the following cases, where the credit in the books satisfies the test of identity and creditworthiness, the Tribunal/High Court deleted the addition made by the AO, by doubting genuineness of the transaction, merely because shares were issued at premium:

- CIT vs. Green Infra Ltd : 392 ITR 7 (Bom.)
- CIT v. Gagandeep Infrastructure P. Ltd.: 394 ITR 680 (Bom.)
- PCIT v. Chainhouse Intl. (P) Ltd.: 98 taxmann.com 47 (MP)
- Hariom Concast & Steel (P) Ltd.: ITA 1775/Hyd./2014 (Hyd.)
- ITO v. Chiropal Poly Films Ltd. (ITA No. 2671/Mum/16) (ITAT Mum)

Interplay – S. 68 v. 56(2)(viib)

ITO v. Chiropal Poly Films Ltd. (ITA No. 2671/Mum/16) – Held,

“We find that Clause (viib) of sub section (2) of section 56 was inserted vide Finance Act, 2012 w.e.f 01 .04.2013 i.e. for and from A. Y. 2013-14 to provide that where a closely held company issues its shares at a price which is more than its fair market value then the amount received in excess of fair market value of shares will be charged to tax in the hand of the company as income from other sources. **This amendment was made keeping in view the practice of closely held companies to brought in undisclosed money of promoters/directors by issuing shares at high premium which is normally over and above the book value of share of the company, and moreover which escaped the provisions of section 68 of the Act..... If one accepts the Ld CIT-DR's contentions that section 68 of the Act can be applied where the transaction is proved to be that of a share allotment that here the valuation for charging premium is not justified, it will make the provisions of section 56(2)(viib) of the Act redundant and nugatory.**”(emphasis supplied)

Interplay – S. 68 v. 56(2)(viib)

Contrary Decisions:

- Sunrise Academy: 409 ITR 109 (Ker.)
- Subhlakshmi Vanijya reported in 155 ITD 171(Kol) –

“A conjoint reading of proviso to section 68 and section 56(2)(viib) divulges that where a closely held company receives, inter alia, some amount as share premium whose genuineness is not proved by the assessee company or its source etc. is not proved by the shareholder to the satisfaction of the AO, then the entire amount including the fair market value of the shares, is chargeable to tax u/s 68 of the Act. If however, the genuineness of the amount is proved and the shareholder also proves his source, then the hurdle of section 68 stands crossed and the share premium, to the extent stipulated, is chargeable to tax u/s 56(2)(viib) of the Act. **It shows that only when source of such share premium in the hands of a shareholder is properly explained to the satisfaction of the AO, that the provisions of section 56(2)(viib) gets triggered.**” (emphasis supplied)

- Sadhvi Securities (P) Ltd. : ITA No. 1047/Del./2019 (Del.)(ITAT)

Favorable Decisions

- 1.Vaani Estate (P) Ltd v. ITO 172 ITD 629(Chennai)
- 2.ACIT v. Subodh Menon [2019] 175 ITD 449(Mum)
- 3.DCIT v. Kumar Pappu Singh [2019] 174 ITD 465(Vishaka)
- 4.Cinestaan Entertainment P. Ltd. vs. ITO: 200 TTJ 459 (Del.)
5. ITO v. Chiropal Poly Films Ltd. (ITA No. 2671/Mum/16)(dated 19/02/19)(ITAT Mum)

4. Rule of Valuation

Rule of Valuation

Explanation.—For the purposes of this clause,—

(a) the fair market value of the shares shall be the value—

(i) as may be determined in accordance with such method as may be prescribed; or

(ii) as may be substantiated by the company to the **satisfaction** of the Assessing Officer, based on the value, **on the date of issue of shares**, of its assets, including intangible assets being goodwill, know-how, patents, copyrights, trademarks, licences, franchises or any other business or commercial rights of similar nature,

- whichever is higher;

Rule of Valuation

Rule 11UA (2)

*(2) Notwithstanding anything contained in sub-clause (b) of clause (c) of sub-rule (1), the fair market value of unquoted equity shares for the purposes of sub-clause (i) of clause (a) of Explanation to clause (viib) of sub-section (2) of section 56 shall be the value, on the valuation date, of such unquoted equity shares as determined in the following manner under clause (a) or clause (b), **at the option of the assessee**, namely:—*

A. NAV, or

B. *the fair market value of the unquoted equity shares determined **by a merchant banker** as per the **Discounted Free Cash Flow method**.*

Rule of Valuation

- NAV or DCF is at the option of the 'A' – No satisfaction of AO is required
- Clause (ii) of the Explanation (a) gives option to the 'A' to substantiate the valuation by any other method, to the 'satisfaction' of the AO, having regard to the value of intangible assets.
- In the absence of satisfaction in NAV or DCF, valuation as per the merchant banker cannot be disregarded by the AO.

Rule of Valuation

- **In other words, AO cannot subjectively disregard the rationale followed by the assessee in following the DCF method.**
 - ✓ Vodafone M-Pesa Ltd v. Pr.CIT (2018) 92 taxmann.com 73 (Bom HC)
 - ✓ Rameshwaram Strong Glass Pvt Ltd v. ITO [2018] 172 ITD 571(Jaipur)
 - ✓ Ozoneland Agro Pvt Limited ITA No. 4854/Mum/2016 order dated 02nd May 2018
 - ✓ Innoviti Payment Solutions (P) Limited: 175 ITD 10 (Bang)
 - ✓ Cinestaan Entertainment P. Ltd. vs. ITO: 200 TTJ 459 (Del.)
 - ✓ Clearview Healthcare: ITA No. 2222/Del./2019 (Delhi ITAT)

Rule of Valuation

- If the valuation is not backed with any material used to arrive at the projections, AO is empowered to completely reject the method and make the addition of premium
 - ✓ TUV Reheinland Nife Academy (P.) LTD. vs. ITO: 55 CCH 0172 BangTrib
 - ✓ Agro Portfolio Pvt Ltd reported in 171 ITD 74(Del)
 - ✓ Microfirm Capital: 168 ITD 301 (Kol.)
- Even para 2.10 of Technical Guide on Share Valuation issued by ICAI acknowledged that future projections forming basis of valuation report are managements responsibility

Rule of Valuation

✓ Agro Portfolio Pvt Ltd reported in 171 ITD 74(Del)

“ 5. In these circumstances, we are unable to accept the contentions of the assessee that in view of the provisions under section 56(2)(viib) of the Act read with Rule 11UA(2) of the Rules the Ld. AO had no jurisdiction to adopt a different method than the one adopted by the assessee, and if for any reason the AO has any doubt recording such valuation report and does not agree with the same is bound to make a reference to the Income tax Department Valuation Officer to determine the fair market value of such capital asset. **This is so because unless and until the assessee produces the evidences to substantiate the basis of projections in cash flow and provides reasonable connectivity between those projections in cash flow with the reality evidences by the material, it is not possible even for the Departmental Valuation Officer to conduct any exercise of verification of the acceptability of the value determine by the merchant banker.**”

Rule of Valuation

- Where AO is not satisfied of the rationale, AO not being an expert, matter should be referred to an expert/Valuation Officer, taking resort to section 142A of the Act.

✓ Rameshwaram Strong Glass Pvt Ltd v. ITO 172 ITD 571(Jaipur)

*“Further, though the AO can scrutinize the valuation report only if some arithmetical mistakes are found, he may make necessary adjustments. But if he finds the working of the C.A. or the assumptions made as erroneous or contradictory, he may suggest the necessary modification and alterations therein provided the same are based on sound reasoning and rational basis **and for this purpose the AO may call for independent expert valuer's report or may also invite comment on the report furnished by the assessee's valuer as the AO is not an expert. It is not open for the AO to challenge or change the method of valuation, once opted by the assessee and to modify the figures as per his own whims and fancies.** In any case, the revenue could not ask to prepare the valuation report based on actuals which is not contemplated in Rule 11UA(2)(b).”*

Reference to Valuation Officer

Section 142A- Estimation of value of assets by Valuation Officer.

(1) The Assessing Officer may, for the purposes of assessment or reassessment, make a reference to a Valuation Officer **to estimate the value, including fair market value,** of any asset, property or **investment** and submit a copy of report to him.

.....

(3) The Valuation Officer, on a reference made under sub-section (1), shall, for the purpose of estimating the value of the asset, property or investment, have all the powers that he has under section 38A of the Wealth-tax Act, 1957 (27 of 1957).

(4) The Valuation Officer shall, estimate the value of the asset, property or investment after taking into account such evidence as the assessee may produce and any other evidence in his possession gathered, **after giving an opportunity of being heard to the assessee.**

(5) The Valuation Officer may estimate the value of the asset, property or investment to the best of his judgment, if the assessee does not co-operate or comply with his directions.

(6) The Valuation Officer shall send a copy of the report of the estimate made under sub-section (4) or sub-section (5), as the case may be, to the Assessing Officer and the assessee, within a period of six months from the end of the month in which a reference is made under sub-section (1).

(7) The Assessing Officer may, on receipt of the report from the Valuation Officer, and after giving the assessee an opportunity of being heard, take into account such report in making the assessment or reassessment.

Explanation.—In this section, "Valuation Officer" has the same meaning as in clause (r) of section 2 of the Wealth-tax Act, 1957 (27 of 1957).]

Rule of Valuation

- **Valuation report cannot be rejected merely because projections do not match the actual results:**
 - ✓ Innoviti Payment Solutions (P) Ltd.: 175 ITD 10 (Bang)
 - ✓ India Today Online P. Ltd.: 104 taxmann.com 385 (Delhi - Trib.)
 - ✓ Vodafone M Pesa (Mumbai ITAT) (1073/M/19)

5. Variance in the method of Valuation of NAV for 56(2)(x) and 56(2)(viib)

NAV Valuation of Shares

Rule 11UA(1)(b) – S. 56(2)(x)

- **FMV of following assets in the Balance Sheet:**

- ✓ Jewellery
- ✓ Shares
- ✓ Immoveable Property (Circle Rate)

- **Date of Balance Sheet**

- ✓ Valuation date, i.e., the date of transaction

Rule 11UA(2)(a) – S. 56(2)(viib)

- **Book Value of all assets, including following assets:**

- ✓ Jewellery
- ✓ Shares
- ✓ Immoveable Property

- **Date of Balance Sheet**

- ✓ Option to take last available audited Balance Sheet

Method of Valuation - Discriminatory

Facts

- Company A Ltd.
- Face Value – Rs. 100
- NAV as per Rule 11UA(2)(a) – Rs. 150
- NAV as per Rule 11UA(1)(b) – Rs. 210
- A Ltd. issued shares at premium of Rs. 75 to Mr. A, aggregate price of Rs. 175

Different Method of Valuation

Deemed income in the hands of A Ltd. u/s 56(2)(viib) – (Rs. 175 – Rs. 150) = RS. 25

Deemed income in the hands of Mr. A u/s 56(2)(x) – (Rs. 210 – Rs. 175) = Rs. 35

Total Deemed Income = Rs. 60

Same Method of Valuation

Deemed income in the hands of A Ltd. u/s 56(2)(viib) – (Rs. 175 – Rs. 210) = NIL

Deemed income in the hands of Mr. A u/s 56(2)(x) – (Rs. 210 – Rs. 175) = Rs. 35

Total Deemed Income = Rs. 35

THANK YOU!