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July 2022

Conversion of Compulsory Convertible Debentures (CCDs) into Equity shares would fall within the purview of S. 56(2)(viib)

The Kolkata Income Tax Appellate Tribunal ("ITAT") in their recent ruling [1] has ruled that the provisions of S. 56(2)(viib) would apply on conversion of CCDs

Background

(i) Milk Mantra Dairy Pvt. Ltd. (the "Assessee") is a private limited company engaged in the manufacturing and selling of dairy products. Assessee entered into an agreement on 31.01.2011 with its investors (venture capital funds, non-residents, and other angel investors) for issuance of CCDs.

(ii) CCDs were issued in tranches in AY 2011-12 & AY 2012-13 and were converted into equity shares in AY 2013-14 at a pre-determined range of FMV.

(iii) During the course of assessment proceedings, AO alleged that the issue of equity shares has been made over and above the FMV and applied the provisions of Rule 11UA(2)(a) by adopting NAV method of valuation for computing the FMV (which was ₹ (294)/-). Since the FMV as per the NAV method was negative, he added the entire consideration amount to tax.

(iv) Assessee filed an appeal before the CIT(A). During the proceedings, CIT(A) gave partial relief to the Assessee by deleting the addition of amount received from non-residents by holding that S. 56(2)(viib) of the Act is applicable only on proceeds received from residents. CIT(A) also gave relief by deleting the addition pertaining to the receipt of face value of shares by holding that S. 56(2)(viib) of the Act is applicable only on the "consideration for issue of shares that exceeds the face value of share" i.e., share premium and not the face value of the shares.

(v) Aggrieved by partial relief from CIT(A), Assessee filed an appeal with ITAT and submitted that entire consideration was received by the Assessee at the time of issuance of CCDs i.e., in AY 2011-12 and AY 2012-13. Conversion by issuing of equity shares did not entail any further payment of money and provisions of S. 56(2)(viib) cannot be applied as conversion price was pre-determined which was agreed upon between the parties in terms of the investment agreement entered into by the parties prior to the insertion of aforesaid provisions.

[1] *ITA No. 413/Kol/2020 in case of Milk Mantra Dairy Private Limited v/s. DCIT [Circle 12(1) Kolkata]*

ITAT's decision

The ITAT after examining the facts and representations from both the Company as well as the Revenue held as under:

(i) Consideration can partake many forms and is not just limited to only receipt of money. Upon conversion of CCDs into equity shares, ***"considerations"*** which the Assessee ***"receives"*** are enumerated as under :

a. extinguishment of debt obligation
b. release of charge created on the assets / properties of the Assessee to secure the debt obligation
c. mitigation of cost of servicing of debt
d. widening of the capital base in form of own fund by leveraging the capital / stock market
e. favorable debt to equity ratio making it more investor attractive / lucrative
f. mitigation of debt obligation thereby reducing risk of getting into the claim of insolvency resolution

As a result, the conversion of CCDs into equity shares in AY 2013-14 entails receipt of consideration by the Assessee making provisions of S. 56(2)(viib) applicable in cases of conversion of securities in the year in which conversion takes place.

(ii) S. 56(2)(viib) shall not apply where the consideration for issue of shares is received by a venture capital undertaking(VCU) from a venture capital company(VCC) or a venture capital fund(VCF) and non-residents.

(iii) Under S. 56(2)(viib) read with Rule 11UA(2), the Assessee is free to opt between DCF or NAV method for valuation, and the method so opted by the Assessee cannot be disregarded by the AO for applying the valuation method of AO's choice.

(iv) As regards the FMV of shares is concerned, ITAT directed the Assessee to make available the MIS data and all other details of various assumptions adopted to arrive at the given valuation of equity shares issued by it. AO was also directed to analyse the data and projections which have undergone in arriving at the FMV on the basis of DCF method opted by the Assessee and make a note if the FMV calculated is appropriate as per law.

Key Takeaways

ITAT's decision has extended the applicability of provisions of S. 56(2)(viib). It is not restrictive to issuance of shares but also covers conversion of securities into equity shares, within its purview. It has a wider applicability and companies must make a note of the same before issuing hybrid instruments.

Cases referred by Assessee:
-India Today Online (P.) Ltd. v. ITO [2019]
-ACIT vs. Diach Chemicals & Pigments Pvt. Ltd. in ITA No. 546/Kol/2017
-Vodafone M-Pesa Ltd. v. DCIT [2018]
-Rockland Diagnostics Services Pvt. Ltd. v. ITO in ITA No. 316/Del/2019 dated 25.02.2021.
-Cinestaan Entertainment Pvt. Ltd. v. ITO in ITA No. 8113/Del/2018 dated 27.05.2019.
-Sri Sakthi Textiles Ltd. v. DCIT in ITA No. 1228/Chn/2019 dated 01.02.2021.

Cases referred by ITAT in its decision:
-Chryso India Pvt. Ltd. (2019) (Kol) dated 19.06.2019
-CIT vs. SPL's Siddhartha Ltd. [2012] (Delhi).
-Innoviti Payment Solutions Pvt. Ltd. v. ITO [ITS-4-ITAT-2019(Bang.)]

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For any further details or questions, please contact us:

India Offices

Ravi Mehta
Managing Director & Head
Transaction Tax
ravi.mehta@rbsa.in
+91 22 6130 6052

Amrita Bhatnagar
Associate Director
Transaction Tax
amrita.bhatnagar@rbsa.in
+91 22 6130 6071

Mumbai
1121, Building No. 11, 2nd Floor,
Solitaire Corporate Park, Chakala,
Andheri Kurla Road, Andheri (E),
Mumbai – 400 093
Tel: +91 22 6130 6000

Delhi
2nd Floor, IAPL House,
23 South Patel Nagar,
New Delhi – 110 008
Tel: +91 11 2580 2300
+91 99585 62211

Ahmedabad
912, Venus Atlantis Corporate Park,
Anand Nagar Road, Prahladnagar,
Ahmedabad – 380 015
M: +91 97243 44445
Tel: +91 79 4050 6000

Bengaluru
104, 1st Floor, Sufiya Elite,
#18, Cunningham Road,
Near Sigma Mall,
Bangalore – 560 052
M: +91 97435 50600
Tel: +91 80 4112 8593

Gift City (IFSC)
Unit No. 16, Office No. 7,
Wing D GIFT Aspire Block 12,
Road 1-D, GIFT SEZ,
Gandhinagar – 382 355
M: +91 97243 43847

Hyderabad
607, 6th Floor, Shangrila Plaza,
Road No. 2, Opposite KBR Park,
Banjara Hills,
Hyderabad – 500 034
M: +91 90526 60300

Kolkata
Office No. 110, DBS House,
10/2 Picasso Bithi,
Hungerford Street,
Kolkata – 700 017
Tel: +91 33 4050 9200

Global Offices

Dubai
2001-01, Level 20, 48 Burj Gate Tower,
Downtown, Sheikh Zayed Road,
PO Box 29734, Dubai, UAE
M: +971 52 382 2367
+971 52 617 3699
Tel: +971 4518 2608
Email: dubai@rbsa.in

Singapore
6001 Beach Road,
#22-01 Golden Mile Tower,
Singapore – 199589
M: +65 8589 4891
Email: singapore@rbsa.in

enquiry@rbsa.in
www.rbsa.in