

Taxation on Issue, Conversion and Transfer of Shares



Karnataka State Chartered Accountants Association (R)

CA Krishna Upadhyaya S

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Outline

Taxation on issue of shares

Taxation on conversion of shares

Taxation on transfer of shares

Q & A



Taxation on Issue of Shares



Taxation on Issue - implications to the issuing company



- ✓ Issue of shares are typically for the following consideration:
 - Money
 - Consideration in kind
 - Conversion of a past debt
 - ESOP or Sweat Equity
- ✓ A need was felt by Government to curb inflated valuation on issue of shares by Companies and using the mechanism of allotment of shares as a method to swindle money
- ✓ 56(2)(viib) was inserted by Finance Act, 2012 w.e.f 01.04.2013
- ✓ Taxation on issue of shares already existed under provisions of section 68 - a requirement to prove the source of the source was introduced by Finance Act, 2012
- ✓ Applicable for all class of shares - whether Equity or Preference - **Microfirm Capital Pvt Ltd vs DCIT [2018] 89 taxmann.com 23 (Kolkata - Trib.)**
- ✓ 56(2)(viib) is applicable whether the shares are being issued for consideration in money, in kind or conversion of past debt
- ✓ May not be practical to apply 56(2)(viib) for issue of shares under ESOP or Sweat Equity

Detailed discussion on 56(2)(viib)



- ✓ Issue Price > Face Value
- ✓ Income = Issue Price - FMV
- ✓ FMV shall be:
 - a) As maybe determined in accordance with method prescribed or
 - b) As maybe substantiated to the satisfaction of AO 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 naturewhichever is higher



- ✓ Where the consideration is received from :
 - a) VC Fund or VC Company or a specified fund [Category I or II AIF regulated by SEBI (maybe a Company, LLP or Trust or a body corporate)] or
 - b) A class of company as maybe notified - detailed discussion in the subsequent slides

Detailed discussion on 56(2)(viib) contd...

✓ Relevant rules : 11U and 11UA

11UA(2) prescribes the method for the purpose of 56(2)(viib) for equity shares

11UA(1)(c) would be applicable for other types of shares

✓ Two methods

- a) Book value method
- b) FMV determined under Discounted Cash Flow(DCF) method as determined by a merchant banker



Detailed discussion on 56(2)(viib) contd...

Notified class of company for which rigorous of 56(2)(viib) does not apply :-



Ministry of Finance - CBDT

Notification no. So 1160(e)[no. 45/2016 (F. No.173/103/2016-ita-i], - person u/s 2(31) investing in a start-up	14-06-2016
Notification no.so 2088(e) [no.24/2018 (f.no.370142/5/2018-tpl (pt)]	24-05-2018
Notification S.O. 584(E) [notification no. 9/2019/F. No. 370142/5/2018-TPL (PT.)]	31-01-2019
Notification S.O. 1131(E) [notification no. 13/2019/f. No. 370142/5/2018-TPL (PT.)]	05-03-2019



Ministry of Commerce - Department for Promotion of Industry and Internal Trade (DPIIT)

Gazette Notification No G.S.R. 180 (E) of Government of India	17-02-2016
Gazette Notification No. G.S.R. 501(E)	23-05-2017
G.S.R. 364(E)	11-04-2018
Notification No. GSR 127 (E) [F.No.5 (4)/2018-SI]	19-02-2019

Detailed discussion on 56(2)(viib) contd...

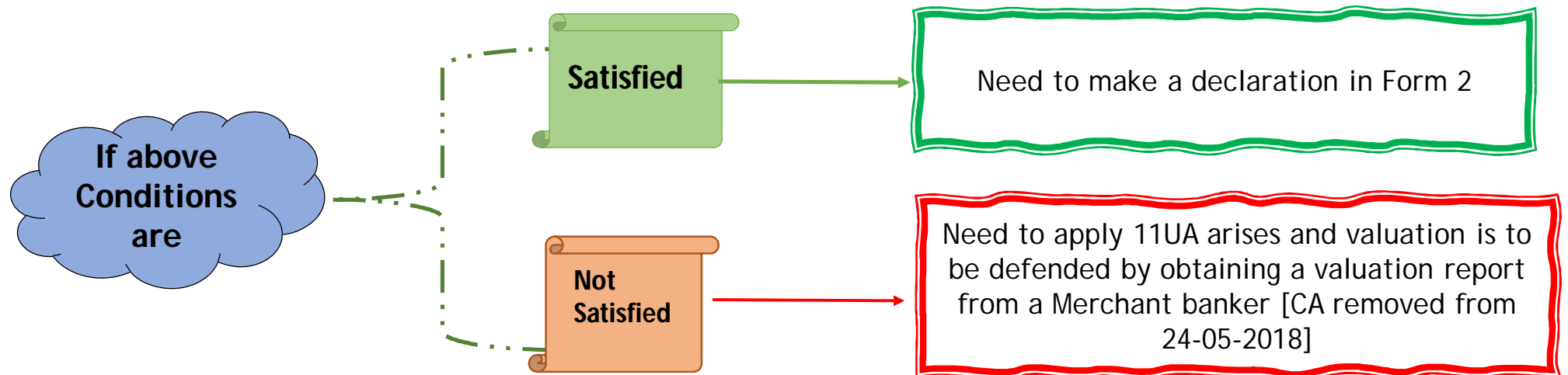
Conditions to be fulfilled to avail exemption from 56(2)(viib)



- ✓ Startup being Company, Registered Partnership or LLP
- ✓ Turnover does not exceed Rs.100 crores
- ✓ Entity is working towards innovation, development or improvement of products or processes or services, or if it is a scalable business model with a high potential of employment generation or wealth creation.
- ✓ Not formed by splitting up or reconstruction
- ✓ Eligible upto 10 years from the date of incorporation
- ✓ Such a startup to make an application to DPIIT with Certificate of Incorporation and a write-up about itself
- ✓ DPIIT may call for information and recognise it as a startup
- ✓ Once recognised, if PUC + Share premium is not exceeding Rs.25 crores

Detailed discussion on 56(2)(viib) contd...

- ✓ In computing Rs.25 crores - investment by Non Residents or VC company or fund or Specified company is not calculated
- ✓ "specified company"
 - a) means a company whose shares are frequently traded within the meaning of Securities and Exchange Board of India (Substantial Acquisition of Shares and Takeovers) Regulations, 2011
 - b) Whose net worth on the last date of financial year preceding the year in which shares are issued exceeds 100 crore rupees or turnover for the financial year preceding the year in which shares are issued exceeds 250 crore rupees.
- ✓ Further, the startup should not have made investments in any prohibited assets or should not make it in the next 7 years from the end of FY where exemption from 56(2)(viib) claimed



Detailed discussion on 56(2)(viib) contd...

- ✓ Can AO disturb the valuation based on the premise that projections carried out and the actual results are different ?
- ✓ Should AO appoint another valuer in case he wishes to carry out a fresh valuation ?
 - ✓ Innoviti Payment Solutions Pvt Ltd vs ITO [2019] 102 taxmann.com 59 (Bangalore ITAT)
 - ✓ Vodafone m-pesa Ltd vs PCIT [2018] 92 taxmann.com 73 (Bom)
 - ✓ India Today Online Pvt Ltd vs ITO ITA No. 6453 & 6454/Del/2018 (Delhi ITAT)
- ✓ Whether the fact that, investments are made by unrelated investors and therefore it is a pure commercial decision and cannot be questioned, holds any water ?
 - ✓ PCIT vs Chain hose International Pvt Ltd [2018] 98 taxmann.com 47(MP)
 - ✓ Cinestaan Entertainment Pvt Ltd vs ITO [2019] 106 taxmann.com 300 (Delhi ITAT)



Application of Section 68

Lovely Exports Delhi High Court
affirmed by Supreme Court in
CIT vs Lovely Exports (P.) Ltd.
[2008] 216 CTR 195 (SC)



✓ 1st proviso to section 68 states as under:

Provided that where the assessee is a company (not being a company in which the public are substantially interested), and the sum so credited consists of share application money, share capital, share premium or any such amount by whatever name called, any explanation offered by such assessee-company shall be deemed to be not satisfactory, unless—

- a. the person, being a resident in whose name such credit is recorded in the books of such company also offers an explanation about the nature and source of such sum so credited; and
 - b. such explanation in the opinion of the Assessing Officer aforesaid has been found to be satisfactory
- ✓ Once the complete records of the share holders are provided, it is the onus of the AO to make necessary enquiry. If such person enquired does not offer any explanation, then section 68 in the hands of the Company can be invoked.

Implications for the investor



- ✓ Earlier 56(2)(viiia) - Specified companies and Firm
- ✓ 56(2)(x) - Applicable from 1st April 2017 and applies for any person
- ✓ Whether the provisions of section 56(2)(viiia) earlier and currently the provisions of section 56(2)(x) applies for the investors, if shares are received for consideration lesser than FMV?
- ✓ CBDT circular:
 - CIRCULAR NO. 10/2018 [F.NO. 173/626/2018-ITA.I], DATED 31-12-2018 - withdrawn
 - CIRCULAR NO. 02/2019[F.NO. 173/616/2018-ITA-I], DATED 4-1-2019
 - CIRCULAR NO. 3/2019 [F.NO. 173/616/2018-ITA.I], DATED 21-1-2019 - Comprehensive circular
- ✓ The term used in the section 56(2)(x) is 'receives' - can that cover a fresh issue or does it presuppose that there must have been shares already in existence ?
- ✓ Can there be 2 sections covering the same transaction from both the sides - Company and investor - which necessarily means that shares have to be issued exactly at FMV.

Implications for the investor contd...

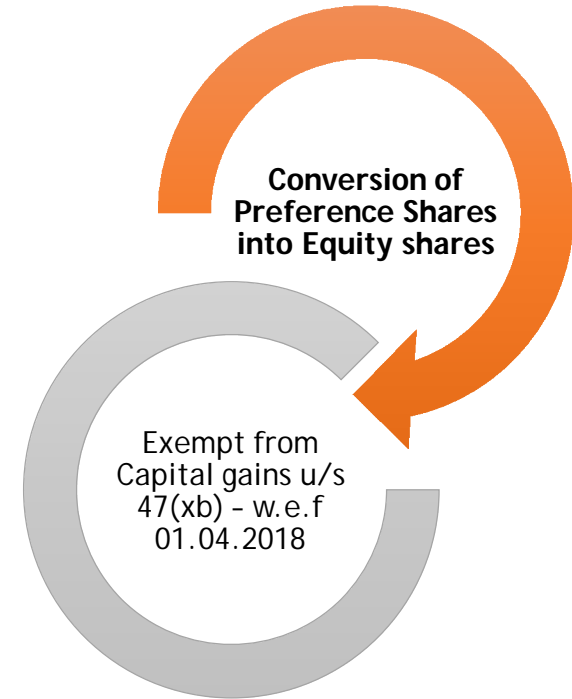
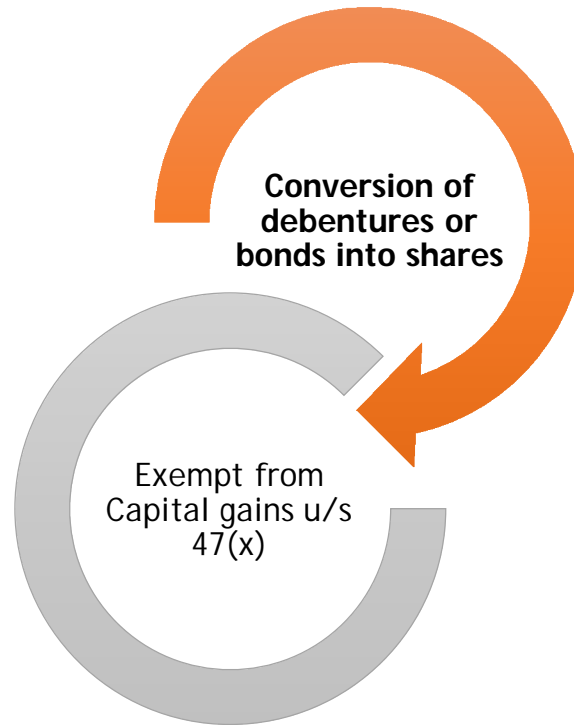
- ✓ 56(2)(x) - FMV is based on adjusted book value as per 11UA(1)(c)(b) and not DCF
- ✓ Only in ideal world both the FMV will be same - So does that mean there will be income arising to investor always on issue on fresh shares ?
- ✓ Does the above cover even issue of bonus shares, right shares or preference shares?
 - ✓ Provisions of section 56(2)(vii) and 56(2)(x) should not apply for receipt of bonus shares - **CIT vs Smt. Mamta Bhandari [2019] 108 taxmann.com 207 (Delhi - Trib.)**
- ✓ In the case of issue of shares as ESOP or Sweat Equity - Rule 3 determines the FMV
 - ✓ For unlisted shares, it is prescribed that such valuation will be as carried out Merchant Banker. In case the value as determined under Rule 3 is different from Rule 11UA(1)(c)(b), can there be taxation u/s 56(2)(x)?





Taxation on Conversion of Shares

Conversion of Debenture or Preference Share into Equity Shares



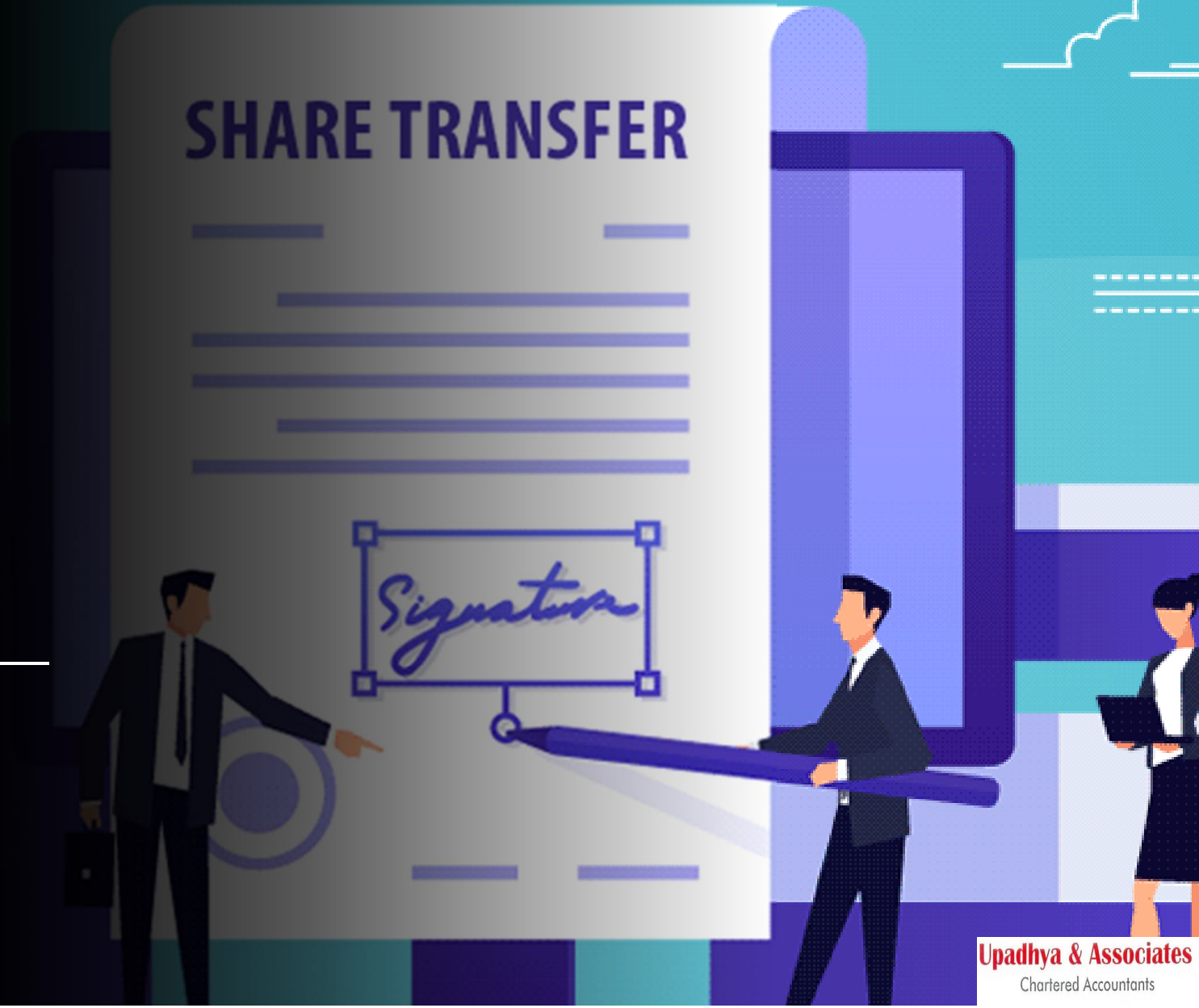
Conversion of Debenture or Preference Share into Equity Shares Contd...

- ✓ Earlier to the above date - position was similar - **Periar Trading Company Pvt Ltd vs ITO, Mumbai [2018] 100 taxmann.com 263 (Mumbai - Trib.)**
- ✓ If the conversion of one instrument into shares, result into premium on such conversion, then the provisions of section 56(2)(viib) for the Company could still apply **to the company**
 - ✓ The only argument could be that 56(2)(viib) contemplates taxation in the year in which consideration is received. However, in case of conversion if receipt of money on issue of original instrument and its conversion are in 2 different years, can there be still taxation u/s 56(2)(viib) in the year of conversion?
- ✓ On conversion, if the instrument given up has a value less than the instrument obtained, then there could be a trigger of 56(2)(x) **for the investor**



CONVERSION

Taxation on Transfer of Shares



Transfer of shares



Sale

Buy Back

Capital Reduction

Redemption

Liquidation

Transfer of shares

Company

No Tax Implication -
*except in the case of
buyback and capital
reduction*

Transferor

There would be
trigger of Capital
gains

Transferee

There could be the trigger of taxation
u/s 56(2)(x) if the shares are purchased at
value less than FMV



Transfer of shares cont.....

For Transferor

Unlisted shares

- ❖ Long term asset/capital gains if held for more than 24 months otherwise short term capital gains
- ❖ Capital gains computed by reducing the cost/indexed cost of acquisition from Sale consideration
- ❖ In case of ESOP or Sweat Equity, the cost shall be the value which is considered as perquisite u/s 17
- ❖ 50CA requires that in case the FMV of the shares transferred are higher than the value at which the shares are transferred, then FMV shall be considered as deemed sale consideration



Transfer of shares cont.....

For Transferor

Unlisted shares

- ❖ 11UAA provides the manner in which FMV is to be determined
- ❖ Date of determining FMV is the date of transfer of such shares
- ❖ 11UAA refers it back to 11UA(1)(c)(b) - equity shares and 11UA(1)(c)(c)- other than equity shares
- ❖ 11UA(1)(c)(b) - Adjusted book value method based on Balance sheet drawn on the date of transfer and audited by auditor appointed by the Company under Companies Act
- ❖ 11UA(1)(c)(c) - Value that the transfer will fetch in open market determined by a Merchant Banker or CA



Transfer of shares cont.....

For Transferor

Listed
shares

- ❖ Long term asset/capital gains if held for more than 12 months otherwise short term capital gains
- ❖ 50CA is not applicable
- ❖ For shares acquired before 1st Feb 2018, cost as per section 55(2)(ac): **higher of**
 - 1 The cost of acquisition of such asset and
 - 2 lower of
 - a. The FMV of such asset on 31st Jan 2018 and
 - b. The full value of consideration received or accruing as a result of the transfer of the capital asset.
- ❖ Taxation u/s 112A @ 10% of the capital gains more than 1,00,000 and STCG @ 15%
- ❖ Losses, if any can be carried forward for 8 years



Transfer of shares cont...



For Transferee

Unlisted shares

Listed shares

56(2)(x) - if the shares are purchased at value less than FMV

If they are equity shares - FMV for this purpose is adjusted book value on the valuation date as per 11UA(1)(c)(b) and not DCF

Other than equity shares - as per 11UA(1)(c)(c) - Value that the transfer will fetch in open market as on the valuation date determined by a Merchant Banker or CA

Transfer of shares cont...

Listed shares

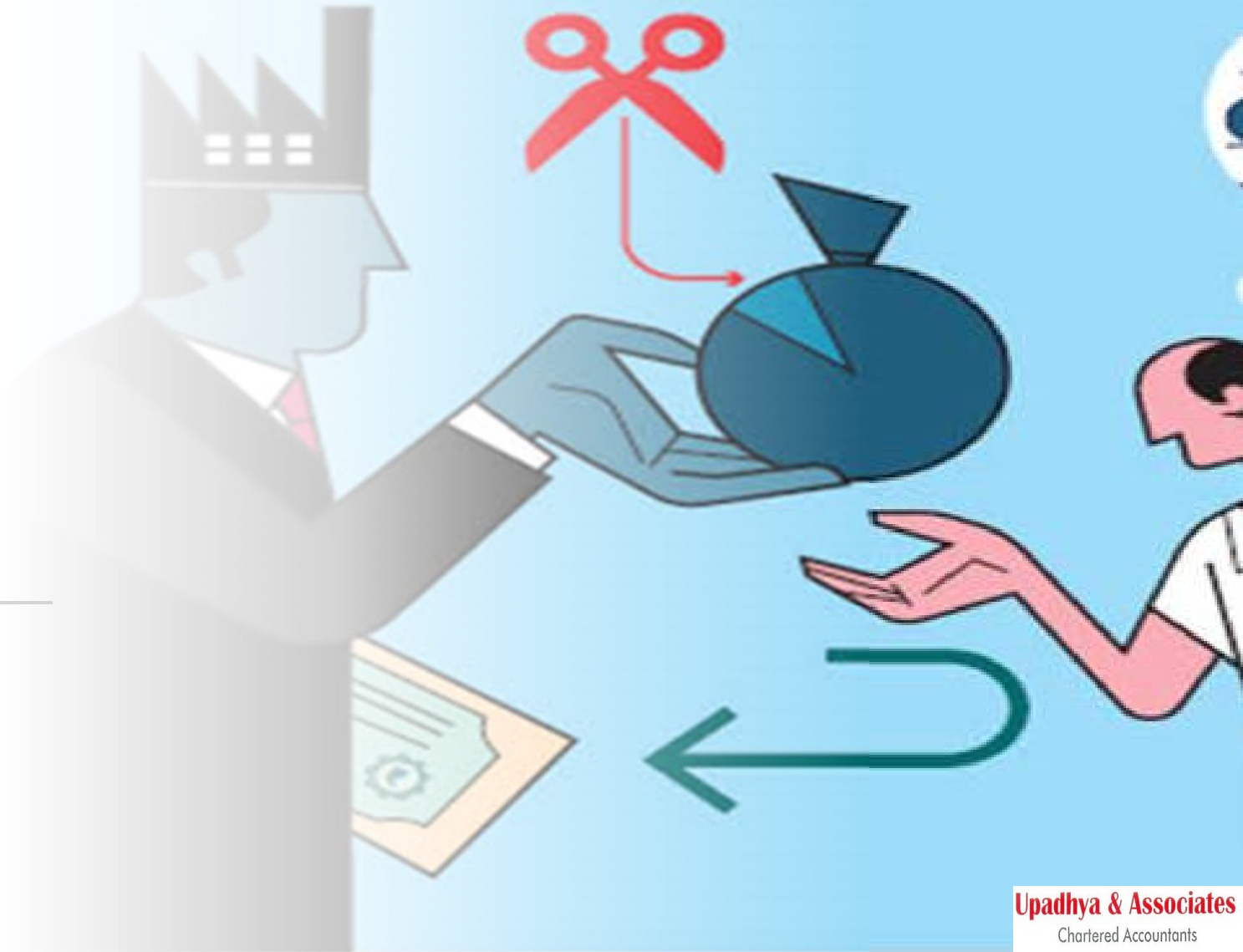
56(2)(x) - If the shares are purchased at value less than FMV

As per 11UA(1)(c)(a)

- A. transacted through any recognised stock exchange - value as recorded in the recognised stock exchange
- B. Transacted other than through recognised stock exchange
 - i. lowest price quoted on any recognised stock exchange on the valuation date
 - ii. lowest price quoted on any recognised stock exchange on a date immediately preceding the valuation date, when there is no trading on the valuation date



Taxation on Buy Back of Shares



Taxation on Buy Back of Shares (section 115QA)



- ✓ Buy back is provided for u/s 68 of Companies Act, 2013
- ✓ Taxation has been introduced as part of FA 2013
- ✓ Currently applicable to all Indian companies u/s 115QA
- ✓ BBT applicable on value paid by Company on buyback less amount received at the time of issue of shares
 - a) Amount paid by shareholder for acquiring shares irrelevant in case of purchase from another shareholder
- ✓ Company with adequate reserves may substitute earlier issued shares by bonus shares (1:1 issue) and buyback old shares - benefit of one time tax free repatriation to the extent of original investment by promoter
- ✓ Corresponding exemption for income of participating shareholder u/s 10(34A)



Taxation on Capital Reduction

Taxation on Capital Reduction

- ✓ Capital Reduction is provided for u/s 66 of Companies Act, 2013
- ✓ Capital Reduction is taxable as deemed dividend to the extent of accumulated profits u/s 2(22)(d)
- ✓ DDT is applicable @ applicable rates
- ✓ Transfer over and above accumulated profits would be considered as a transfer and capital gains would be applicable in the hands of the shareholder
- ✓ Where no distribution and value of share extinguished whether capital loss available?

- A. No capital loss as per Mumbai SB decision in case of Bennett Coleman vs. ACIT
- B. Capital loss allowed in case of Bangalore ITAT in case of Jupiter Capital Pvt. Ltd

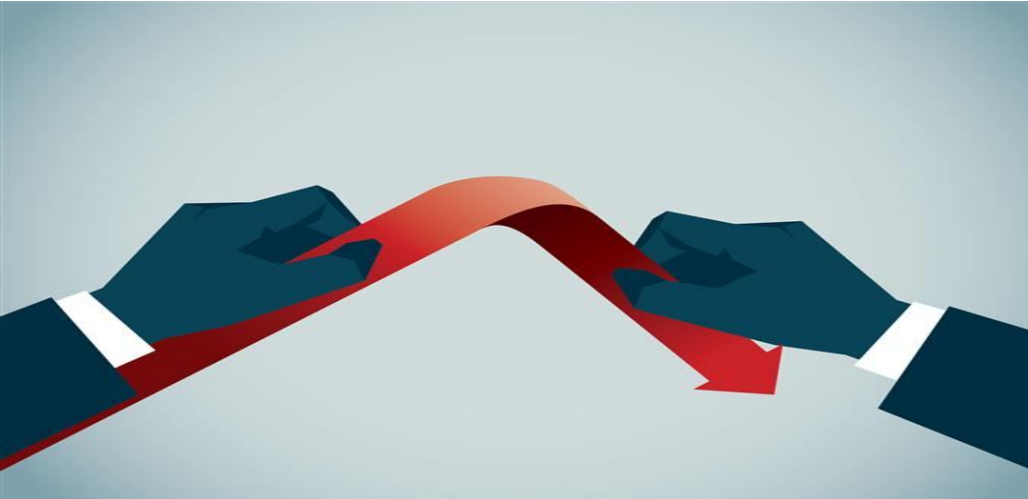


Taxation on Redemption of Preference Shares and Liquidation



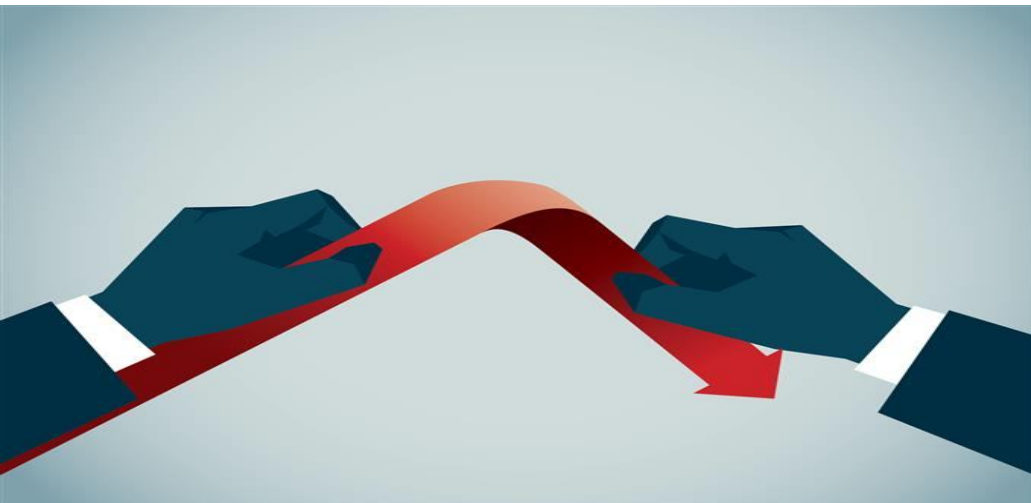
Taxation on Redemption of Preference Shares

- ✓ S. 46A covers gains on purchase of shares / securities by a company
- ✓ Redemption is considered as transfer and capital gains are applicable
- ✓ Deemed dividend provisions inapplicable as redemption of preference shares not considered as capital reduction



Taxation on Liquidation

- ✓ S. 46 covers gains on liquidation
- ✓ To the company, there is no taxation
- ✓ To the share holder:
 - ✓ To the extent that there are accumulated reserves, consideration is taxable as Dividend u/s 2(22)(c)
 - ✓ In excess of that, it is taxable as capital gains







Thank You
CA Krishna Upadhya S

KARNATAKA STATE
CHARTERED ACCOUNTANTS ASSOCIATION^(R)



Upadhya & Associates
Chartered Accountants