SUPER PREMIUM TAXATION, A NEED OR AN OBLIGATION?

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On February 1, 2023, the Hon'ble Finance Minister, Nirmala Sitharaman, presented the Union Budget of India for the FY 2023.

A key amendment that has been proposed, is removal of the words 'being a resident' from section 56(2)(viib) of the Income Tax Act, 1961 ('the IT Act'). Accordingly, it is proposed that the scope of taxation of unjustifiable premium (quantum of consideration being higher than FMV of shares of the company as determined in the valuation report) has now been extended to include both resident as well as non-resident investors.

Existing provision for taxation of super premium

Section 56(2)(viib) of the IT Act was inserted vide Finance Act, 2012, in order **to deter the generation and circulation of unaccounted money through subscription of shares of a closely held company,** at a **value** which is **higher than the Fair Market Value** ('FMV') of shares of such company.

By virtue of section 56(2)(viib) of the IT Act, it states that, 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 FMV of the shares** shall be **deemed to be the income of the concerned company** chargeable to tax **under the head Income from other Sources** for the relevant financial year.

Hence the applicability of the above is as summarized below:

1. Shares must be issued at premium to a resident (Issue price > Face value); and
2. Consideration should be greater than FMV (Issue price > FMV)

Both the above conditions need to be fulfilled for applicability of section 56(2)(viib) of the IT Act. Accordingly, in case, if answer to condition no. (1) is no, then even if answer to condition no. (2) is yes, there are no adverse tax implications under section 56(2)(viib) of the IT Act, and vice-versa.

Non-applicability of the said section:

- Company receiving consideration is a company in which public are substantially interested *(i.e., as defined under section 2(18) of the IT Act)*
- Consideration is received by a venture capital company or venture capital fund or other notified company
- **Consideration is received by a non-resident investor**

For the purposes of section 56(2)(viib) of the IT Act, FMV of shares shall be higher of the following:

A. *As per the methods prescribed under Rule 11UA(2) of the Income Tax Rules, 1962 (' the Rules') which are*

i. *Book value Method (NAV) and*

ii. *Discounted Cash flow method (to be obtained from a* ***category I merchant banker*** *registered with Securities and Exchange Board of India), or*

B. *Any other value as may be substantiated by the company to the satisfaction of the Assessing Officer.*

Therefore, pursuant to the above provision, in the event where the company receiving consideration upon issuance of fresh shares to the investors, being resident in India, at premium, which is not justifiable, then such unjustifiable premium would deemed to be the income of the concerned company u/s 56(2)(viib) of the IT Act, chargeable to tax under the head Income from other Sources for the relevant financial year.

Proposed amendments on taxation of super premium by expanding its scope to include non-residents

A. Interplay between proposed provision and Indian exchange control regulations ('FEMA')

The proposed amendment will have significant impact on the primary infusions where issuance of shares is being made by Indian companies to the entities which are incorporated outside India / individuals who are tax resident outside India. Further, it is to be noted that as it stands today a venture capital undertaking receiving funds from a specified investors is outside the purview of the angel tax provisions. **The proposed amendment restricts Indian companies from receiving consideration for issuance of shares at a price higher than its FMV as determined under the Rules.**

Further, it is pertinent to note that, from FEMA perspective, any consideration receivable by an Indian company from a non-resident investor against issue of shares, to be equal to or more than the FMV determined based on any internationally accepted pricing methodology. Accordingly, it can be said **that non-residents are expected to invest at a minimum valuation which is determined based on internationally accepted pricing methodology. There is no cap on the maximum amount that can be paid against acquiring shares of an Indian company.**

Thus, the combined reading of section 56(2)(viib) of the IT Act and FEMA regulations suggests that all the investments that are proposed to be made by non-resident investors in shares of the closely held company, would need to comply with relevant provisions of IT Act and FEMA regulations simultaneously.

However, it is to be noted that under the FEMA provisions, unlike under IT Act read with the Rules, methodology for determination of fair value has not been prescribed. Accordingly, there may be a situation wherein fair value under FEMA regulations and as per the provisions of IT Act (i.e., 11UA valuation) may differ.

Suppose fair value of a share computed under FEMA regulation is INR 100, whereas under FMV under IT Act is INR 80. Now, let's assume the shares are issued to foreign investors at INR 100. In such case, the tax department will seek to tax INR 20 (i.e.,100-80) as income in the hands of the recipient company.

Further, the proposed amendment is prone to litigation (including tax authorities rejecting fair valuation certificates provided by companies) as it has been a case with the startups in relation to angel tax in the past several years.

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

The provisions of section 68 of the IT Act are 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. On the application of the sections 68 and 56(2)(viib) of the IT Act, it may be contended by the revenue authorities that both anti-avoidance measures are being introduced with different objectives. **Further, none of these provisions override the other and thus, co-exist.** Thus, where the share consideration exceeding FMV is subjected to tax under section 56(2)(viib) of the IT Act and further revenue authorities are not satisfied with the explanation provided in respect of nature and source of the consideration received, provisions of section 68 of the IT Act may be applicable. 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 IT Act.

It is to be noted that, the proposed amendment moves evidently beyond the explicit purpose behind introduction of section 56(2)(viib) back in 2012, which was to curb the menace of money laundering in the system. **Considering that in case of subscription of shares by non-residents, typically the payment would have come from proper banking channels through an authorised dealer, with appropriate KYC documentation, the chances of money being laundered is remote.**

C. 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 IT Act that inter-alia, provides for taxability of income in respect of international transactions to be computed having regard to arm's length price. Considering that the provisions of section 56(2)(viib) of the IT 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 IT Act. **Pursuant to 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 IT Act, thereby increasing compliance obligation of Indian companies.**

In a Nutshell

The proposed amendment does not effectively cater to solve the issues around money laundering from foreign sources. Rather it would not be harsh to say that the proposed amendment is contrary to the Government's initiative of ease of doing business as it increases compliance burden as well as potential litigation around fair valuation of shares, which in turn may affect the FDI inflows into India.

Further, in order to reduce various controversies as highlighted above, it is sought that the Finance Bill, 2023 provides necessary clarifications / reliefs to the various aspects around primary infusion by non-residents, thereby, not adversely impacting the FDI inflow into India.