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cutting through complexity

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Issue of shares is an ‘international transaction’ but not an ‘income chargeable to tax’ warranting the substitution of such income with income determined on the basis of its ALP

Background

Recently the Delhi Bench of the Income-tax Appellate Tribunal (the Tribunal) in the case of First Blue Home Finance Ltd.[1] (the taxpayer), following the Bombay High Court (High Court) decision in the case of Vodafone India Services Pvt. Ltd.[2] held that the Transfer Pricing (TP) adjustment on account of interest on the deemed loan due to under-receipt of share premium cannot be called for. However, a transaction arising as a result of the original transaction which may have an impact on income of the taxpayer, would require determination of Arm’s Length Price (ALP) under the provisions of Chapter X of the Income-tax Act, 1961 (the Act).

Facts of the case

- The taxpayer, a wholly owned subsidiary of BHW Holding AG, is engaged in the business of providing loans to retail customers for the construction or purchase of residential properties in India. During the year, the taxpayer reported two international transactions viz. issue of share capital and provision of services. The latter was accepted by the Transfer Pricing Officer (TPO) at ALP.

- For the transaction of issue of share capital, the taxpayer applied the comparable uncontrolled price method and concluded that to be at ALP. Having observed that the book value of a share i.e. INR13.70 is higher than the issue price per share i.e. INR10, the TPO remarked that the taxpayer has transferred the assets of the company in the mode of issue of share capital. Thus, by determining the ALP at INR13.70 per share, the TPO concluded that such under-charging of the share price amounting to INR4,740 lakh tantamount to a deemed loan for which the taxpayer ought to have been compensated with an appropriate interest by its Associated Enterprises (AEs).

- By applying the benchmark interest rate of 14 per cent on such deemed loan, the TPO made a TP adjustment of INR664 lakh, which was affirmed by the first appellate authority.

Proceedings before the Tribunal

- The moot question before the Tribunal was whether any addition towards TP adjustment on account of interest on deemed loan can be made. By referring to the Section 92(1) of the Act, the Tribunal held that to compute the income arising from an international transaction having regard to the ALP, the following two conditions should be satisfied cumulatively:

  (i) There should be an international transaction; and

  (ii) Such international transaction should result into income chargeable to tax.

- Citing the provisions of Chapter X of the Act and placing reliance on the landmark judgments of the Bombay High Court in the case of Vodafone and Shell India Markets[3], the Tribunal held that:

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[1] First Blue Home Finance Ltd. v. ACIT [ITA No. 5460/Del/2011] –Taxsutra.com
[2] Vodafone India Services Private Limited v. ACIT [2014] 368 ITR 1 (Bom)

[3] Shell India Markets Pvt. Ltd. v. ACIT and Others, [2014] 369 ITR 516 (Bom)

- The transaction of issue of share is an international transaction under Section 92B of the Act, as the same has bearing on the assets of the taxpayer. A reference to the amendment made by Finance Act, 2012 is also drawn by the Tribunal which included capital financing transactions within the ambit of international transaction.

- If an international transaction with its determined ALP does not lead to the generation of any income chargeable to tax, then the provisions of Section 92(1) of the Act are not attracted.

- In the case of Vodafone, it is held that Chapter X of the Act does not contain any charging provisions but is a machinery provision to arrive at the ALP of an international transaction. Also, Chapter X does not change the character of the receipt but only permits re-quantification of income independent of the relationship between the AEs.

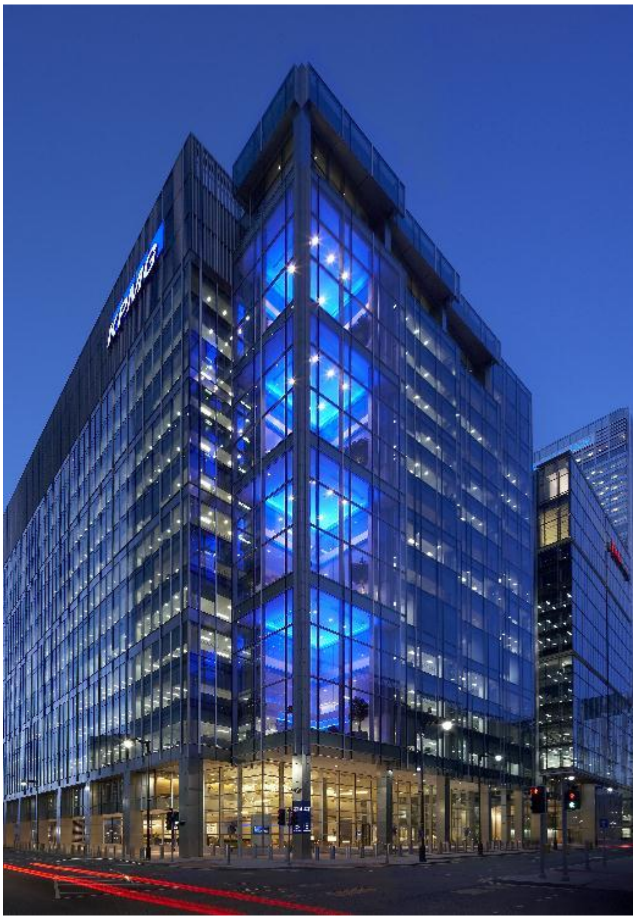
- In view of the definition of income which does not specifically include any capital receipt arising on issue of share capital within its purview, the issue of shares at par or premium is a transaction of capital nature, which would not have impact on income of a company.

- Referring to the provisions of the clause (viib) of Section 56(2) of the Act inserted vide Finance Act 2012, the Tribunal held that they are prospective in nature and can be attracted in case where the share capital is issued to a resident by a taxpayer. Moreover, this provision activates only when a company issues shares at a price above the fair market value and not *vice versa.* Thus, in view of all of the above, this provision is not applicable in the taxpayer's case and thus, there can be no question of substituting the transacted value of the international transaction with its ALP.

• The Tribunal held that the transaction on capital account or on account of restructuring would become taxable to the extent it impacts income i.e. under reporting of interest income, over reporting of interest paid or claiming of depreciation, etc. In other words, an international transaction of capital nature may not lead to generation of any income itself but the resultant transaction may have impact on the income of the taxpayer which, if is not at arm's length, would invoke and need to satisfy the provisions of Chapter X of the Act.

Our comments

Pursuant to the High Court ruling in the case of Vodafone and Shell, this ruling further strengthens two key principles envisaged by Chapter X of the Act i.e. transfer pricing provisions should not be applied in the absence of any income arising from a particular transaction and issue of share/s by a company at par (or at a premium or discount), though qualifies to be an international transaction but is capital in nature and therefore not subject to tax.



www.kpmg.com/in

Ahmedabad
Commerce House V, 9th Floor,
902 & 903, Near Vodafone House,
Corporate Road,
Prahlad Nagar,
Ahmedabad – 380 051
Tel: +91 79 4040 2200
Fax: +91 79 4040 2244

Bengaluru
Maruthi Info-Tech Centre
11-12/1, Inner Ring Road
Koramangala, Bangalore 560 071
Tel: +91 80 3980 6000
Fax: +91 80 3980 6999

Chandigarh
SCO 22-23 (Ist Floor)
Sector 8C, Madhya Marg
Chandigarh 160 009
Tel: +91 172 393 5777/781
Fax: +91 172 393 5780

Chennai
No.10, Mahatma Gandhi Road
Nungambakkam
Chennai 600 034
Tel: +91 44 3914 5000
Fax: +91 44 3914 5999

Delhi
Building No.10, 8th Floor
DLF Cyber City, Phase II
Gurgaon, Haryana 122 002
Tel: +91 124 307 4000
Fax: +91 124 254 9101

Hyderabad
8-2-618/2
Reliance Humsafar, 4th Floor
Road No.11, Banjara Hills
Hyderabad 500 034
Tel: +91 40 3046 5000
Fax: +91 40 3046 5299

Kochi
Syama Business Center
3rd Floor, NH By Pass Road,
Vytilla, Kochi – 682019
Tel: +91 484 302 7000
Fax: +91 484 302 7001

Kolkata
Unit No. 603 – 604,
6th Floor, Tower – 1,
Godrej Waterside,
Sector – V, Salt Lake,
Kolkata 700 091
Tel: +91 33 44034000
Fax: +91 33 44034199

Mumbai
Lodha Excelus, Apollo Mills
N. M. Joshi Marg
Mahalaxmi, Mumbai 400 011
Tel: +91 22 3989 6000
Fax: +91 22 3983 6000

Noida
6th Floor, Tower A
Advant Navis Business Park
Plot No. 07, Sector 142
Noida Express Way
Noida 201 305
Tel: +91 0120 386 8000
Fax: +91 0120 386 8999

Pune
703, Godrej Castlemaine
Bund Garden
Pune 411 001
Tel: +91 20 3050 4000
Fax: +91 20 3050 4010