Transfer Pricing Provisions Not Applicable to Allotment of Shares

The author discusses the recent decision of the Bombay High Court in the Vodafone India Services Pvt. Ltd case, in which the Court held that the issuance of shares at a premium by a subsidiary to its non-resident parent company does not give rise to any income and, as a consequence, the provisions of chapter X relating to avoidance of tax (transfer pricing) of the Indian Income Tax Act 1961 is not applicable.

1. Introduction

This article analyses the decision of the Bombay High Court (the Court) in the Vodafone India Services Pvt. Ltd v. Union of India case, specifically on the applicability of transfer pricing provisions under chapter X of the India Income Tax Act 1961 (ITA 1961) to the allotment of shares by an Indian subsidiary company to its non-resident parent company. The Court held that because there is income that arises from such a transaction, the allotment of shares would not be amenable to transfer pricing provisions. This ruling is noteworthy because many companies, in order to finance their subsidiary companies, invest by subscribing to shares of its subsidiary, and the case therefore brings certainty to their investment by not subjecting it to the transfer pricing provisions.

2. Facts of the Case

Vodafone India Services Pvt. Ltd. (Vodafone India), an Indian entity, is a wholly owned subsidiary of Vodafone Tele-Services (India) Holdings Limited (Vodafone Holding), a non-resident entity. Vodafone India and Vodafone Holding are associated enterprises under chapter X of the ITA 1961. Vodafone India was in need of certain funds for its telecommunication services project in India and, in this context, Vodafone Holding made certain investments during financial year 2008-09 by subscribing to the share capital of Vodafone India. Vodafone India, pursuant to the investment in share capital, allotted 289,224 equity shares with a face value of INR 10 each, at a premium of INR 8,509 per share, to Vodafone Holding. For the allotment of shares by Vodafone India to Vodafone Holding, a total consideration of INR 246.38 crores was paid by Vodafone Holding. The fair market value of the equity shares was determined to be INR 8,519 per share in accordance with the methodology prescribed by the Indian government under the Capital Issues (Control) Act 1947.

Vodafone India filed its return of income along with Form 3-CEB in accordance with section 92E of the ITA 1961. In Form-3CEB, the transaction of allotment of equity shares by Vodafone India to Vodafone Holding was declared as an international transaction, and the arm’s length price of the shares so issued was also determined. A note was appended to Form 3-CEB which clarified that the transaction of issuance of equity shares did not affect the income of Vodafone India and that the transaction was reported only as a matter of abundant caution.

3. Proceedings before the Authorities

The assessing officer issued a notice under section 143(2) of the ITA 1961 to Vodafone India for the purposes of carrying out a scrutiny assessment. The assessing officer referred all transactions reported by Vodafone India in Form 3-CEB to the transfer pricing officer. This was in order to determine the arm’s length price of the reported international transactions in accordance with section 92CA(1) of the ITA 1961. The assessing officer and the transfer pricing officer were of the opinion that Vodafone India ought to have valued each equity share at INR 53,775 (rather than INR 8,519 per share) under the Capital Issues (Control) Act 1947. The shortfall in premium per share was INR 45,256, resulting in a total shortfall of INR 1308.91 crores. Thus, the assessing officer and transfer pricing officer, on application of the transfer pricing provisions contained in chapter X of the ITA 1961, concluded that this amount of INR 1308.91 was income and must be treated as a deemed loan given by Vodafone India to Vodafone Holding and periodic interest thereon must be charged to tax as interest income of INR 88.35 crores in financial year 2008-09.

Vodafone India filed its objections to the order of the assessing officer with the Dispute Resolution Panel. The jurisdiction of the assessing officer and the transfer pricing officer to undertake a transfer pricing adjustment was challenged by Vodafone India before the Court, and the Court directed Vodafone to submit its objection to the Panel. As a result, Vodafone India filed its preliminary objections contesting the jurisdiction of the tax authorities to apply chapter X of the ITA 1961, primarily on the ground that no income arose upon the issuance of equity shares by Vodafone India to its holding company. This was because such issuance of shares neither gives rise to income nor impacts the income of Vodafone India.

The Dispute Resolution Panel held that the non-receipt of the premium, to the extent not received, is income...
arising from the issuance of shares. It further concluded that section 92(1) of the ITA 1961 mandates that the computation of income arising out of an international transaction reflect the arm’s length price. The term “income” is not defined in chapter X and must be construed in a broad manner, embracing all types of receipts or incomings. The Panel relied upon section 2(24) of the ITA 1961, which defines income in an inclusive manner, and capital receipts that would otherwise not be covered by the term “income” would also be included in the definition. Therefore, the Panel concluded that all incomings would fall within the concept of income. The order further noted that as a consequence of Vodafone India’s failure to receive the arm’s length price on the issuance of shares, a lesser premium was obtained by Vodafone India. Thus, Vodafone India would have less liquid funds available at its disposal which in turn could have reduced its debt, or the excess funds could have been invested to earn income. Thus, the amount not received could have enhanced its potential income. Based on these findings, the Panel concluded that the foregone share premium impacted potential income, thus giving rise to the application of chapter X of the ITA 1961 to the issuance of shares.

This order of the Panel was challenged before the Court by means of a writ petition.

4. Submissions of the Parties

The following submissions were made on behalf of Vodafone India:

- Under section 92(1) of the ITA 1961, any income arising from an international transaction must be computed by having regard to the arm’s length price. Thus, the sine qua non for application of section 92(1) of the ITA 1961 is that income is to arise from an international transaction. In the present case, no income arises from the issuance of equity shares by Vodafone India to Vodafone Holding.

- The term “income” must be understood as defined by other provisions of the ITA 1961, such as section 2(24). A tax law provision must be strictly interpreted upon its own terms and the meaning of ordinary words may not be expanded to give an inferred interpretation.

- For any transaction to be brought to tax under chapter X, taxable income must arise. This was absent in the case in hand.

- The Dispute Resolution Panel erroneously concluded that the share premium on the issuance of shares is perse not taxable, and it is only the amount of the share premium which is deemed not to have been received by Vodafone India by application of the arm’s length price, that is liable to tax.

- In the issuance of shares, the shares come into existence for the first time only when the shares are allotted. An issuance of shares is a process of creation of shares and not a transfer of shares. Therefore, there is no transfer of shares so as to render section 45 of the ITA 1961 (relating to capital gains) applicable.

- The issuance of shares by Vodafone India to Vodafone Holding and the receipt of consideration by Vodafone India is a capital receipt under the ITA 1961, and thus may not be brought to tax unless specifically expressly brought to tax by the ITA 1961.

- Explanation (i)(c) to section 92B of the ITA 1961 merely states that a capital financing transaction, such as borrowing money and/or lending money to an associated enterprise, would constitute an international transaction. However, what is brought to tax is not the quantum of the amount loaned and/or borrowed, but rather the impact on income due to such lending or borrowing (e.g. interest paid/interest received). Similarly, explanation (i)(e) to section 92B of the ITA 1961, which covers business restructurings, would apply only if the restructuring or reorganization impacts income. In the present case such a contingency does not arise, as there is no impact on income which would be chargeable to tax due to the issuance of shares.

The following submissions were made on behalf of the tax authorities:

- A joint reading of section 92(1) and section 92(2) of the ITA 1961 indicates that what is being brought to tax under chapter X of the ITA 1961 is not the share premium, but rather the cost incurred by Vodafone India in passing on a benefit to Vodafone Holding through the issuance of shares at a premium less than the arm’s length price. This benefit is the difference between the arm’s length price and the premium at which the shares were issued.

- Vodafone India, by filing Form 3-CEB, has submitted to the jurisdiction of the authorities under chapter X by declaring the arm’s length price for the allotment of shares to Vodafone Holding. Therefore, when it was discovered that the arm’s length price was not correct, the assessing officer and the transfer pricing officer were required to apply chapter X of the ITA 1961 and compute the correct arm’s length price.

- Section 92(1) of the ITA 1961 uses the expression “any income arising from an international transaction”, which indicates that the income of either party to the transaction could be the subject matter of tax (and not only the income of resident).

- What is taxable is income when it accrues or arises or when it is deemed to accrue or arise, and this is not restricted to when it is received. Therefore, even if an amount is not actually received, if income has arisen or has been deemed to arise, then the same is chargeable to tax.
5. **Ruling of the High Court**

5.1. **Meaning of the term “income”**

The term “income” is defined in section 2(24) of the ITA 1961, which is an inclusive definition. The term “income” normally does not include capital receipts unless specified in the said definition, such as section 2(24)(vi) of the ITA 1961 which relates to capital gains arising out of specified transactions. In such cases, the capital gains chargeable to tax under section 45 of the ITA 1961 are defined to be income. The Court noted that the receipt of an amount upon the issuance of share capital, including the premium, is a capital account transaction. Share premiums are rendered taxable by a legal fiction under section 56(2)(viib) of the ITA 1961, and the same is enumerated as income in section 2(24)(xvi) of the ITA 1961. However, what is brought into the ambit of income is the premium received from a resident in excess of the fair market value of the shares.

In the present case, what is being sought to be taxed is capital not received from a non-resident, i.e. premium not received by Vodafone India. Thus, due to the absence of an explicit legal provision, no amount received, accrued or arising upon a capital account transaction, may be subject to tax as income. In this regard, the Court referred to its ruling in the **Cadell Weaving Mill Co.** case, which was upheld by the Supreme Court in the **D.P. Sandu Bros. Chembur Pvt. Ltd.** case.

It is well-settled that all receipts are not taxable under the Income Tax Act. Section 2(24) defines “income.” It is no doubt an inclusive definition. However, a capital receipt is not income under Section 2(24) unless it is chargeable to tax as capital gains under Section 45. It is for this reason that under Section 2(24)(vi) that the Legislature has expressly stated, inter alia, that income shall include any capital gains chargeable under section 45. Under Section 2(24)(vi), the Legislature has not included all capital gains as income. It is only capital gains chargeable under Section 45 which has been treated as income under Section 2(24). If the argument of the Department is accepted then all capital gains whether chargeable under Section 45 or not, would come within the definition of the word “income” under Section 2(24). Further, under Section 2(24)(vi) the Legislature has not stated that “any capital gains” will be covered under the word “income.” On the contrary, the Legislature has advisedly stated that only capital gains which are chargeable under Section 45 of the Act could be treated as income. In other words, capital gains not chargeable to tax under Section 45 fall outside the definition of the word “income” in Section 2(24) of the Act. It is true that Section 2(24) of the Act is an inclusive definition. However, in this case, we are required to ascertain the scope of Section 2(24)(vi) and for that purpose we have to read the sub section strictly. We cannot widen the scope of subsection by saying that the definition as a whole is inclusive and not exhaustive. In the present case, the words “chargeable under Section 45” are very important. They are not being read by the Department. These words cannot be omitted. In fact, the prior history shows that capital gains were not chargeable before 1946. They were not chargeable between 1948 and 1956. Therefore, whenever an amount which is otherwise a capital receipt is to be charged to tax, Section 2(24) specifically so provides.

The Court further noted that the definition of income under section 2(24)(xvi) of the ITA 1961 includes within its scope the provisions of section 56(2)(vii-b) of the ITA 1961, which implies that the Parliament intended to tax the issuance of shares to a resident, in cases where the issue price is above the fair market value. In the present case, the issuance of shares is to a non-resident company, and thus it appears that the Parliament had consciously not brought to tax amounts received from a non-resident for the issuance of shares, as that would discourage capital inflow from abroad.

Based on the above, the Court was of the view that the capital receipts received by Vodafone India from Vodafone Holdings on the issuance of equity shares, or the alleged shortfall between the fair market price of equity shares and the issue price of the equity shares is not to be considered as income within the meaning of the term as defined under the ITA 1961.

5.2. **Interpretation of taxing statutes**

The Court noted that when interpreting a taxing statute, in case the provision by itself is susceptible to two or more meanings, it is not permissible to forgo the strict rules of interpretation when construing it. In this context, the Court relied on the decision of the Supreme Court in the **Mathuram Agrawal** case, which laid down the following test for interpreting a taxing statute:

The intention of the Legislature in a taxation statute is to be gathered from the language of the provisions particularly where the language is plain and unambiguous. In a taxing Act it is not possible to assume any intention or governing purpose of the statute more than what is stated in the plain language. It is not the economic results sought to be obtained by making the provision which is relevant in interpreting a fiscal statute. Equally impermissible is an interpretation which does not follow from the plain, unambiguous language of the statute. Words cannot be added to or substituted so as to give a meaning to the statute which will serve the spirit and intention of the legislature. The statute should clearly and unambiguously convey the three components of the tax law i.e., the subject of the tax, the person who is liable to pay the tax and the rate at which the tax is to be paid. If there is any ambiguity regarding any of these ingredients in a taxation statute then there is no tax in law. Then it is for the legislature to do the needful in the matter.

Therefore, the Court noted that it was not open to Dispute Resolution Panel to have recourse to the supposed intent of the legislature to give a broader meaning to the term “income” than what was contemplated by the ITA 1961 or the Parliament.

5.3. **Transactions not intended to be covered by chapter X**

The Court rejected the reliance of the tax authorities on the definition of “international taxation” in subclauses (c) and (e) of explanation (i) to section 92B of the ITA 1961.
concluding that the term “income” must be given a broader meaning so as to include notional income – otherwise chapter X of the ITA 1961 would be rendered ineffective. The Court noted that the issuance of shares at a premium does not exhaust the universe of applicability of chapter X of the ITA 1961. A transaction on capital account or on account of restructuring would become taxable to the extent that it impacts income (e.g. the under-reporting of interest or over-reporting of interest paid, or the claiming of depreciation). It is that income which is to be adjusted to the arm’s length price and not taxed as capital receipts.

The Court further noted that the entire exercise of determining the arm’s length price is only to arrive at the real income earned, i.e. the correct price of the transaction, agreed between the parties on account of their relationship (i.e. associated enterprises). Furthermore, chapter X of the ITA 1961 offers a mechanism to arrive at the arm’s length price of a transaction between associated enterprises. The substantive charging provisions are found in sections 4, 5, 15 (salaries), 22 (income from house property), 28 (profits and gains of business), 45 (capital gains) and 56 (income from other sources). Even income arising from an international transaction between associated enterprises must satisfy the test of income under the ITA 1961 and must find its home under one of the above heads (i.e. charging provisions).

5.4. Joint reading of section 92(1) and 92(2)

The Court observed that the argument of the tax authorities was unique wherein the tax authorities asserted that section 92(1) must be read with section 92(2) of the ITA 1961, and that a joint reading would indicate that the cost incurred in passing on the benefit to the holding company is being subject to tax, rather than the share premium not received. The Court held that this was a unique way of reading a provision, specifically the omission of words in the section. This manner of reading the provision, by ignoring or rejecting certain words, without any finding that in the absence of such a rejection, the provision would become unworkable, is certainly not a permitted mode of interpretation.

Section 92(2) of the ITA 1961 relates to an arrangement between associated enterprises whereby they are to receive any benefit, service or facility, and requires that the allocation, apportionment or contribution towards the cost or expenditure be determined in respect of each associated enterprise having regard to the arm’s length price. The Court illustrated this by noting that in the case of costs of research carried on by an associated enterprise for the benefit of three associated enterprises, the cost is to be distributed (i.e. allocated, apportioned or contributed) depending upon the arm’s length price of such benefit to be received by the assessed associated enterprise. This will not have any application in the present case, as there is no occasion to allocate, apportion or contribute any cost and/or expenses between Vodafone India and Vodafone Holding.

6. Conclusion

Recently, the Income Tax Appellate Tribunal in the Vijai Electricals Ltd case held that an investment in shares by means of a subscription of shares is not an international transaction under section 92B of the ITA 1961. However, that ruling did not specify the reasons as to why the provisions of chapter X are not applicable, and the ruling related to the applicability of provisions of transfer pricing for outbound investments by Indian companies in their associated companies.

However, this judgement of the Court in the Vodafone case represents a breather for many companies that are presently caught in the web of transfer pricing provisions relating to the allotment of shares. The ruling considered in this article addresses, in detail, why the provisions of chapter X are not applicable and the ruling related to the applicability of provisions of transfer pricing for outbound investments by Indian companies in their associated companies.

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7. IN: ITAT (Hyderabad), 31 May 2013, M/s Vijai Electricals Ltd v. Additional Commissioner of Income Tax, ITA 842/HYD/2012, Tax Treaty Case Law IBFD.