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## Newsflash

**Himachal Pradesh High Court rules that Angel tax provisions would not be applicable on Conversion of Loan into Equity**

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### Himachal Pradesh High Court rules that Angel tax provisions would not be applicable on Conversion of Loan into Equity

*For Circulation  
21 June 2024*

#### 1. Background

- 1.1 Section 56(2)(viib) of the Income Tax Act, 1961 ('the Act') provides that where a closely held company issues shares to any person at a value higher than the face value of shares, then the consideration received in excess of the fair market value (FMV) of such shares shall be taxable as income under the head 'Income from other Sources' in the hands of company issuing the shares. Such excess consideration is commonly referred to as "**Angel Tax**".
- 1.2 The said provision is not applicable where the consideration for issue of shares is received:
  - (a) by a venture capital undertaking from a venture capital company or a venture capital fund or a specified fund, or
  - (b) by a company from persons notified by the Government<sup>1</sup>, or
  - (c) by a start-up company<sup>2</sup>, which fulfills prescribed conditions.
- 1.3 Valuation of shares has consistently been a contentious matter leading to numerous legal disputes. For the purposes of section 56(2)(viib) of the Act, FMV of the unquoted equity shares is determined in accordance with the method prescribed under Rule 11UA<sup>3</sup> of the Income Tax Rules, 1962 ('the Rules').
- 1.4 With respect to issue of equity shares to the resident persons, the said FMV is determined either through the book value method ('NAV') or the discounted cash flow ('DCF') method, **at the option of the company**. In case shares are issued at a price higher than the FMV, excess share premium received gets taxed in the hands of issuer company.

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<sup>1</sup> CBDT, vide Notification No. 29/ 2023 dated May 24, 2023, enlisted specified class of exempted investors which have been discussed in detail , Refer Newsflash dated June 09, 2023- [Newsflash CBDT proposes amendments to Rule 11UA of Income Tax Rules, 1962 in respect of Angel Tax | RSM India](#)

<sup>2</sup> In supersession of Notification No. 13/ 2019 dated March 05, 2019, CBDT, vide Notification No. 30/ 2023 dated May 24, 2023, provided relaxation to start-up companies from angel tax provision, subject to fulfillment of certain conditions.

<sup>3</sup> CBDT, vide Notification No. 81/ 2023 dated September 25, 2023, notified the final amended Rule 11UA for valuation of shares. Refer Newsflash dated October 09, 2023. [Newsflash CBDT amends Rule 11UA of Income Tax Rules, 1962 in respect of Angel Tax | RSM India](#)

- 1.5 Recently, the Hon'ble High Court of Himachal Pradesh in the case of ***Pr. Commissioner of Income Tax-I vs M/s I.A. Hydro Energy (P) Limited<sup>4</sup>***, had an occasion to analyse taxation aspects of converting pre-existing unsecured loan into equity shares under section 56(2)(viib) of the Act and has concurred with the decision passed by the Income Tax Appellate Tribunal [ITAT] and Commissioner of Income Tax (Appeals) [CIT(A)] on non-applicability of angel tax provisions pursuant to conversion of loan into equity shares.

## 2. Facts of the case

- 2.1 The taxpayer, a private limited company is engaged in the business of generation and distribution of hydroelectricity in the state of Himachal Pradesh. The taxpayer was incorporated pursuant to conversion / succession of a partnership firm. For AY 2018-19 ('year under consideration'), the taxpayer company filed its tax return by declaring a loss.
- 2.2 The taxpayer was having an opening balance of unsecured loans, and as per the terms of the agreement, the same got converted into share capital. Prior to conversion of firm into company, the share subscribers were partners in the said firm and their balances were shown as Partners Capital Account.
- 2.3 Pursuant to loan conversion, the taxpayer issued 2.25 crores equity shares (having face value of INR 10 per share) at a premium of INR 90 per share. For the said purposes, it adopted DCF method prescribed under Rule 11UA and also obtained Certificate from a Chartered Accountant<sup>5</sup> to that effect.
- 2.4 The Assessing Officer ('AO') rejected the valuation report furnished by the taxpayer, by contending that the valuation carried out through DCF method was bogus and had no connection with the real figures. It stated that the valuation was done with fictitious figures having no correlation with the actual affairs of the taxpayer and thereafter, computed the FMV of the unquoted shares as per NAV method.
- 2.5 Accordingly, vide order u/s 143(3) of the Act dated April 12, 2021, the AO made an addition of INR 202.5 crores u/s 56(2)(viib) of the Act, on account of excess amount received as premium per share.

## 3. Order of CIT (Appeals) and Hon'ble ITAT (Chandigarh Bench)

- 3.1 The Ld. CIT(A), vide Order dated May 13, 2022, deleted the addition made by the AO on the following grounds:

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<sup>4</sup> ITA No.4 of 2024 (High Court of Himachal Pradesh at Shimla)

<sup>5</sup> While as on date, only Merchant Bankers are authorised to issue DCF valuation report for the purposes of Section 56(2)(viib) pursuant to Notification No.23/ 2018 dated May 24, 2018, however, for the year under consideration, Chartered Accountants could also issue such report.

- Since no money/ consideration was received by the taxpayer in the previous year for issue of shares pursuant to conversion of outstanding loans (source of which was also accepted to be satisfactorily explained), section 56(2)(viib) is not applicable.
  - DCF method is an internationally accepted method of valuation of shares and is also a prescribed methodology as per Rule 11UA(2)(d) of the Rules.
  - Right of selecting the valuation method (DCF or NAV) is vested with the taxpayer. The AO completely acted beyond his jurisdiction by substituting the taxpayer's method of valuation (i.e. DCF) with his own method of valuation (i.e. NAV).
  - Report of the technical expert is binding on the AO and cannot be disregarded/ rejected without any cogent reasons.
- 3.2 Aggrieved by the order of the CIT(A), the Revenue preferred an appeal before the Hon'ble ITAT, which, vide its order dated October 11, 2023, and by placing reliance on the judgement of ITAT Mumbai bench in the case of **Creditalpha Alternative Investment Advisors (Pvt.) Ltd.**<sup>6</sup>, also deleted the addition on the following grounds:
- If no consideration is received by the taxpayer for the allotment of shares during the year under consideration, then Section 56(2)(viib) is not applicable
  - Consideration in the form of unsecured loans was received from the partner of the erstwhile partnership firm in the year 2010, as evidenced from loan agreement. The AO could not bring any material facts to prove that such conversion of loan into equity was done with an intent to evade tax or defraud revenue.
  - Authority to opt for a particular method of valuation is given only to the taxpayer as per Rule 11UA. The AO can only verify the method of valuation adopted by the taxpayer and cannot substitute it with any other method.
  - The AO was not correct in rejecting DCF valuation merely on the ground that there was a huge difference in projected figures and actual results available for some years.

#### 4. Decision of the Hon'ble HP High Court

- 4.1 The Hon'ble High Court of Himachal Pradesh concurred with the findings of the CIT(A) and ITAT and considered them as well reasoned.
- 4.2 It observed that **Section 56(2)(viib) of the Act would have applied only if consideration had been received in the previous year for allotment of such shares**. It was further held that the **AO had no jurisdiction to substitute the NAV method, once the taxpayer had already exercised the option of DCF valuation as per Rule 11UA**.

<sup>6</sup> (2022) 134 Taxmann.com 223 (Mumbai)

- 4.3 The Hon'ble High Court dismissed the Revenue's appeal and found that no substantial questions of law arose in the said appeal before it.

## 5. Key takeaways

- 5.1 The above view is consistent with the decisions pronounced earlier by Tribunals/ High Courts of different jurisdictions on this aspect<sup>7</sup>.
- 5.2 The ruling promotes fair and predictable tax practices by reinforcing the principle that the taxpayers can adopt any valuation method of their choice and the AO cannot arbitrarily substitute the chosen method of taxpayer.
- 5.3 The judgement also reinforces the stand that without any cogent reason or convincing material, the tax department is not justified in making a comparison of the estimations with the actuals. DCF Method is essentially based on projections (estimates), which cannot be compared with the actuals to expect the same figures as were projected.
- 5.4 The ruling provides clarity and reasonable certainty to companies issuing shares at a premium (whether as part of group restructuring or otherwise) that their chosen valuation methods, if compliant with law, should not be disputed.

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<sup>7</sup> Delhi HC in PCIT v. Cinestaan Entertainment Pvt. Ltd. ITA No. 1007/ 2019, Jaipur Tribunal in Rameshwaram Strong Glass (P.) Ltd. v ITO, Ward-2(1), Ajmer [2018] 96 taxmann.com 542, Mumbai Tribunal in DCIT v. Ozoneland Agro (P.) Ltd. ITA No. 4854/Mum/2016, Delhi Tribunal in India Today Online (P.) Ltd. v ITO ITA No. 6453 & 6454/Del/2018, Chennai Tribunal in Vaani Estate (P.) Ltd. V ITO [2018] 98 taxmann.com 92

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This Newsflash summarizes on Himachal Pradesh High Court's ruling on applicability of angel tax provisions on conversion of loan to equity. It may be noted that nothing contained in this newsflash should be regarded as our opinion and facts of each case will need to be analyzed to ascertain applicability or otherwise of the said judgement and appropriate professional advice should be sought for applicability of legal provisions based on specific facts. We are not responsible for any liability arising from any statements or errors contained in this newsflash.

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21<sup>st</sup> June 2024

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