Query No. 9

Subject: Treatment of tax expense on deemed income under section 56(2)(viia) of the Income-tax Act, 1961 arising on purchase of investments.[1]

A. Facts of the Case

1. A company (hereinafter referred to as 'the company') in which public is not substantially interested is incorporated on May 5, 2010 under the Companies Act, 1956 with the object to generate, receive, purchase, develop, use, sell, supply, distribute, transmit and accumulate electrical or any other form of power and energy in general by conventional or non-conventional methods, from any source whether hydro, water, wind, solar, thermal, gas, oil, diesel, nuclear or otherwise at power stations, plants, establishments, works and other ancillary facilities of every kind and description and transmit, distribute and supply such power through transmission lines, cables, wires and other facilities on a commercial basis to cities, towns, streets, docks, factories, markets, buildings and other places both public and private. The company is a wholly owned subsidiary of a company, B Limited, which holds 15% of the equity shares of another unlisted company, C Limited.

2. During the financial year 2010-11, it was decided by the Board of the company to acquire, if possible, all the balance 85% equity shares of C Limited, which were held by other not related shareholders. The company intends to hold this for long term purposes being a strategic investment. Accordingly, the company has acquired additional equity shares (representing balance 85%) from various unrelated parties in separate trenches for an agreed consideration (excluding stamp duty and tax under section 56(2)(viia) of the Income-tax Act, 1961). The acquisitions were at a price lower than the fair value of the said shares calculated in accordance with manner prescribed under Rule 11 (UA) of the Income Tax Rules, 1962.

3. Under the provisions of section 56(2)(viia) of the Income-tax Act, 1961, in the instances, where shares of a company in which the public is not substantially interested are acquired for a consideration which is less than the aggregate fair value of the shares by an amount exceeding Rs. 50,000/-, the excess of the aggregate fair value over the consideration is an income under the head 'Income from Other Sources'.

4. The querist has stated that the company has paid tax on the the excess of the aggregate fair value over the consideration paid in accordance with the requirements of section 56(2)(viia). In addition to the above, the company has also incurred expenses on account of stamp duty, franking and bank charges in connection with the said acquisition.

[1] Opinion finalised by the Expert Advisory Committee on 12.08.2011.

5. According to the querist, the payment of income tax under section 56(2)(viia) has arisen out of the transaction of acquisition of shares and the company would not have incurred such an expense otherwise. The internal business case for acquisition of these shares was justified to the Board by considering the basic cost of acquisition, the transaction costs like stamp duties, the cost of transfer of shares and the tax payable under section 56(2)(viia), i.e., deemed income arising from purchase of investments, which would be directly associated with purchase of such shares.

6. The querist has further stated that the provision of tax under section 56(2)(viia) is a recent addition to the Income-tax Act, 1961, and such a situation of taxes payable due to acquisition is not covered directly in paragraph 9 of existing Accounting Standard (AS) 13, 'Accounting for Investments', which deals with various costs that could be considered as part of cost of acquisition of an investment. In view of this, the querist has referred to relevant technical material from notified[2] Indian Accounting Standards (Ind ASs) for technical guidance on the subject matter.

7. The querist has stated that as per paragraph 11 of Indian Accounting Standard (Ind AS) 32, 'Financial Instruments: Presentation', definition of financial assets includes an equity instrument of another entity. Paragraph 38 of Indian Accounting Standard (Ind AS) 27, 'Consolidated and Separate Financial Statements' provides, inter alia, as follows:

> **"38 For preparing separate financial statements the entity shall account for investments in subsidiaries, jointly controlled entities and associates either:**
>
> **(a) at cost, or**
>
> **(b) in accordance with Ind AS 39"**

Paragraph 43 of Indian Accounting Standard (Ind AS) 39, 'Financial Instruments: Recognition and Measurement', provides as follows:

> **"43 When a financial asset or financial liability is recognised initially, an entity shall measure it at its fair value plus, in the case of a financial asset or financial liability not at fair value through profit or loss, transaction costs that are directly attributable to the acquisition or issue of the financial asset or financial liability."**

As per paragraph 9 of Ind AS 39, "*Transaction costs* **are incremental costs that are directly attributable to the acquisition, issue or disposal of a financial asset or financial liability (see Appendix A paragraph AG13). An incremental cost is one**

[2] The Committee wishes to point out that although Ind ASs have been placed on the website of Ministry of Corporate Affairs, these Standards have not yet been notified by the Ministry.

that would not have been incurred if the entity had not acquired, issued or disposed of the financial instrument."

Paragraph AG 13 of Appendix A, Application Guidance to Ind AS 39, states as follows:

> "AG13 Transaction costs include fees and commissions paid to agents (including employees acting as selling agents), advisers, brokers and dealers, levies by regulatory agencies and securities exchanges, and transfer taxes and duties. Transaction costs do not include debt premiums or discounts, financing costs or internal administrative or holding costs."

8. The querist has stated that in view of the above, especially paragraph 9 of Ind AS 39 and paragraph AG13 of Appendix A to Ind AS 39, the company is of the view that the tax on this notional deemed income is a transaction cost, which otherwise would not have been incurred by the company and should be treated as acquisition cost of the investment and hence, has capitalised the said tax cost.

B. Query

9. The company has considered the basic consideration, stamp duty charges and tax under section 56(2)(viia) as cost of investment in shares in its accounts. The querist believes that the purchase has resulted in a cash outflow on account of tax under section 56(2)(viia) and that this cost is a direct result of the acquisition of these said shares as also it was a part of the business case which justified the overall purchase at the all inclusive price. Had the acquisition of these shares not been made, the company would not have incurred such costs. On the basis of the above, the querist is seeking opinion of the Expert Advisory Committee on the following issues:

(i) whether the payment of tax under section 56(2)(viia) would qualify to be treated as part of the cost of investment in the balance sheet of the company in view of the explanation provided in paragraphs 9 and 43 of Ind AS 39 read along with paragraph AG13 of Appendix to Ind AS 39.

(ii) If answer to (i) is no, what is the correct accounting treatment of such tax expenses on deemed income under section 56(2)(viia) of the Income-tax Act, 1961?

C. Points considered by the Committee

10. The Committee notes that the basic issue raised in the query relates to accounting for tax paid under section 56(2)(viia) in the separate financial statements of the company. The Committee has, therefore, considered only this issue and has not considered any other issue that may arise from the Facts of the Case, such as, accounting for stamp duty, franking and bank charges, cost of transfer of shares and other costs incurred, accounting

in the consolidated financial statements and accounting in the books of holding company or company C, applicability of Ind AS 39 or other Ind ASs in the instant case, etc. Further, the opinion expressed hereinafter, is purely from accounting point of view and not from interpreting any legal enactment, such as, Income-tax Act, 1961.

11. The Committee notes paragraph 56(2)(viia) of the Income-tax Act, 1961, which provides, inter alia, as follows:

> "Where a firm or a company not being a company in which the public are substantially interested, receives, in any previous year, from any person or persons, on or after the 1st day of June, 2010, any property, being shares of a company not being a company in which the public are substantially interested, –
>
> (i) without consideration, the aggregate fair market value of which exceeds fifty thousand rupees, the whole of the aggregate fair market value of such property;
>
> (ii) for a consideration which is less than the aggregate fair market value of the property by an amount exceeding fifty thousand rupees, the aggregate fair market value of such property as exceeds such consideration"

12. The Committee wishes to point out that although Ind ASs have been placed on the website of the Ministry of Corporate Affairs, these Standards have not yet been notified by the Ministry. Accordingly, till the Ind ASs are notified by the Ministry, the existing notified Accounting Standards would be applicable. Therefore, in the instant case, the Committee is of the view that the transaction of acquisition of investment in shares would be governed by the existing notified AS 13.

13. With regard to accounting for the tax levied under section 56(2)(viia) of the Income-tax Act, 1961, the Committee notes paragraph 9 of AS 13, which provides that "the cost of an investment includes acquisition charges such as brokerage, fees and duties". Keeping in view the nature of the items of acquisition charges mentioned in AS 13, the Committee is of the view that the cost of acquisition should include only those direct charges which are incurred 'on' acquisition of investment, i.e., the expenses, without the incurrence of which, the transaction could not have taken place, such as, share transfer fees, stamp duty, registration fees, etc. The Committee notes that tax paid under section 56(2)(viia) is levied when consideration paid for acquisition of investment is lower than its fair market value for an amount exceeding Rs. 50,000 and such lower consideration paid is deemed as income of the assessee acquiring such investment. Thus, this tax is not a tax 'on' acquisition of shares rather it is a tax on 'deemed income' under Income-tax Act, 1961. Accordingly, the Committee is of the view that such tax expense is not a cost incurred 'on' acquisition of investment rather it is incurred after the transaction of the acquisition of investment. In other words, it is not a means of acquiring such investments; rather it is a result of such acquisition. Accordingly, such tax cannot be considered as acquisition-related cost and, therefore, cannot be capitalised as cost of

investment. The Committee is further of the view that such tax paid should be treated as normal tax and charged off to profit and loss account in the year in which it is incurred.

14. Since the querist has sought to take support in this regard from Ind ASs, the Committee has also examined this issue in the framework of Ind ASs independently without relating it to AS 13 or any other existing notified Standard. Under the framework of Ind ASs, the Committee notes that paragraph 38 of Ind AS 27 provides, inter alia, as follows:

> **"38 For preparing separate financial statements the entity shall account for investments in subsidiaries, jointly controlled entities and associates either:**
>
> **(a) at cost, or**
>
> **(b) in accordance with Ind AS 39"**

15. The Committee notes from the above that Ind AS 39 would be relevant only if the entity exercises the option to account for investment in subsidiary under that Standard. It may be noted that if that option is exercised, the Committee notes paragraph 43 of Indian Accounting Standard (Ind AS) 39, 'Financial Instruments: Recognition and Measurement', provides as follows:

> **"43 When a financial asset or financial liability is recognised initially, an entity shall measure it at its fair value plus, in the case of a financial asset or financial liability not at fair value through profit or loss, transaction costs that are directly attributable to the acquisition or issue of the financial asset or financial liability."**

16. Presuming that the investment is not a financial asset at fair value through profit or loss, the Committee notes that paragraph 9 of Ind AS 39 provides, "*Transaction costs* **are incremental costs that are directly attributable to the acquisition, issue or disposal of a financial asset or financial liability (see Appendix A paragraph AG13). An incremental cost is one that would not have been incurred if the entity had not acquired, issued or disposed of the financial instrument."**

17. The Committee further notes that paragraph AG 13 of Appendix A, Application Guidance to Ind AS 39, states as follows:

> "AG13 Transaction costs include fees and commissions paid to agents (including employees acting as selling agents), advisers, brokers and dealers, levies by regulatory agencies and securities exchanges, and transfer taxes and duties. Transaction costs do not include debt premiums or discounts, financing costs or internal administrative or holding costs."

18. The Committee notes from the above provisions of Ind AS 39 that only those transaction costs that are directly attributable to the acquisition of investment can be capitalised with the investment. The Committee is of the view that although the tax levied under section 56(2)(viia) may be considered as an incremental cost of acquisition of investment, it cannot be considered as 'a directly attributable cost' due to the reasons stated in paragraph 13 above. Accordingly, even on considering the relevant provisions of Ind AS 39, such tax levied cannot be capitalised as cost of investment.

D. Opinion

19. On the basis of the above, the Committee is of the following opinion on the issues raised by the querist in paragraph 9 above:

(a) The payment of tax under section 56(2)(viia) does not qualify for capitalisation as a cost of investment in the balance sheet of the company as mentioned in paragraphs 13 and 18 above.

(b) Tax paid under section 56(2)(viia) should be treated as normal tax and charged off to profit and loss account of the year in which it is incurred as discussed in paragraph 13 above.