Tax Hotline

May 07, 2019

TAXATION OF UNEXPLAINED CASH CREDITS: RECENT DEVELOPMENTS

- The Supreme Court allows the addition of share premium to the income of a company once field enquiries revealed that some of new shareholders / subscribers were not existent at the addresses supplied by the company in its explanation to the tax authorities.
- The fact that shareholders had negligible taxable income and were unable to explain the source of the funds used to make the investment at premium in the company held against them by the Supreme Court.
- Mumbai Bench of the ITAT, however, holds that it is not open to a tax officer to question valuation under Section 68 of the ITA.
- ITAT disallows the addition of share premium as income of company where company is able to produce comprehensive documentary evidence demonstrating the genuineness of the transaction.

In this hotline, we discuss three recent judgments which have been pronounced on the subject of the taxation of unexplained cash credits in the form of share capital/ premium under Section 68[1] of the Income Tax Act, 1961 ("**ITA**"). The first is a judgment of the Hon'ble Supreme Court of India in the case of *Principal Commissioner of Income Tax (Central)-1 v. NRA Iron & Steel Pvt. Ltd.*,[2] the second and third are rulings of the Income Tax Appellate Tribunal ("**ITAT**") in the case of *The Income Tax Officer-6(2)(1), Mumbai v. M/s. Chiripal Poly Films Ltd.*,[3] and in the case of *M/s. Abhijeet Enterprise Ltd. v. Income Tax officer, Wd-2(2), Kolkata*[4]

LEGISLATIVE BACKGROUND:

Section 68 is an anti-abuse provision which has been inserted in the ITA to bring into the tax net, cash for which no satisfactory explanation (about its nature and source) is furnished by a taxpayer. This section provides that where any sum is credited to the books of a taxpayer for which the taxpayer is unable to offer a satisfactory explanation to the tax authorities, such sum is to be treated as the income of the taxpayer and taxed as such.

In 2012, this provision was amended and two provisos were added which strengthened the burden on closely held companies to establish the source of the funds received by it while exempting cash received from venture capital funds from the ambit of the provision.

The Memorandum to the Finance Bill, 2012 explained the need for the addition of the proviso to Section 68 of the ITA as below:

"In the case of closely held companies, investments are made by known persons. Therefore, a higher onus is required to be placed on such companies besides the general onus to establish identity and creditworthiness of creditor and genuineness of transaction. This additional onus needs to be placed on such companies to also prove the source of money in the hands of such shareholder or persons making payment towards issue of shares before such sum is accepted as genuine credit. If the company fails to discharge the additional onus, the sum shall be treated as income of the company and added to its income."

PRINCIPAL COMMISSIONER OF INCOME TAX (CENTRAL)-1 V. NRA IRON & STEEL PVT. LTD.[5]

NRA Iron & Steel Pvt. Ltd. (the "**Taxpayer**") received money aggregating to INR 17,60,00,000 as share capital/premium during the Financial Year 2009-10 from the various companies situated at Mumbai, Kolkata, and Guwahati. These shares had a face value of INR 10 per share but were subscribed to by the investors/ subscribers at INR 190 per share. The issue before the Assessing Officer ("**AO**") was whether the amount of INR 17,60,00,000 raised by the Taxpayer through share capital/premium were genuine transactions or not.

The Taxpayer submitted that the entire share capital had been received by it through normal banking channels by account payee cheques /demand drafts, and produced documents such as income tax return acknowledgments of its investors to establish the identity and genuineness of the transaction. On this basis, it submitted that there was no cause to take recourse to Section 68 of the ITA, and that the onus on it stood fully discharged.

The AO had issued summons to the representatives of the investor companies. Despite the summons having been served, nobody appeared on behalf of any of the investor companies. The AO independently got field enquiries conducted with respect to the identity and credit-worthiness of the investor companies, and to examine the genuineness of the transaction. The results of such enquiries were as follows:

1. No investor could justify making investment at such a high premium of INR 190 for each share, when the face value of the shares was only INR 10.
2. Some of the investor companies were found to be non-existent.
3. Almost none of the companies produced the bank statements to establish the source of funds for making such a

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huge investment in the shares, even though they were declaring a very meagre income in their returns

4. None of the investor-companies appeared before the AO, but merely sent a written response through post.

Since the genuineness could not be established by the investors, the amount of INR 17,60,00,000/- was added back to the total income of the Taxpayer for the assessment year in question. The Taxpayer relied upon the Delhi High Court in *CIT* v. *Lovely Exports Pvt. Ltd.*[6], wherein it was held that a company may discharge the onus under Section 68 of the ITA if it is able to provide the relevant details such as the address and PAN of the investor along with copies of the shareholders register, share application forms, share transfer register, etc., and that the Department would not be justified in drawing an adverse inference only because the creditor/subscriber fails or neglects to respond to its notice.

The Commissioner of Income Tax (Appeals) ("**CIT(A)**"), deleted the addition made by the AO on the ground that the Taxpayer had filed confirmations from the investor companies, along with their Income Tax Return, acknowledgments with PAN and copies of their bank account to show that the entire amount had been paid through normal banking channels and hence, had discharged the initial onus under Section 68 of the ITA for establishing the credibility and identity of the shareholders. The Income Tax Appellate Tribunal ("**ITAT**") dismissed the appeal of the revenue department and confirmed the order of the CIT(A). The revenue department preferred an appeal against this order of the ITAT before the Delhi High Court which also dismissed this appeal.

The revenue department then approached the Hon'ble Supreme Court of India against the judgment of the Delhi High Court.

The Supreme Court referred to its own judgment in the case of *CIT v. P. Mohankala*[7] where it has been held that the expression "*the assessee offers no explanation*" used in Section 68 of the ITAT means the taxpayer offers no proper, reasonable and acceptable explanation as regards the sums found credited in the books maintained by the taxpayer.

The Guwahati High Court in *Nemi Chand Kothari* v. *CIT*[8] held that merely because a transaction takes place by cheque is not sufficient to discharge the burden. The Taxpayer has to prove the identity of the creditors and genuineness of the transaction.

The Supreme court laid down the following principles regarding the treatment of share capital /premium from the perspective of Section 68 of the ITA after referring to a catena of case law[9]:

1. A taxpayer company is under a legal obligation to prove the genuineness of the transaction, the identity of the creditors, and credit-worthiness of the investors who should have the financial capacity to make the investment in question, to the satisfaction of the AO, so as to discharge the primary onus.
2. The AO is duty bound to investigate the credit-worthiness of the creditor/ subscriber, verify the identity of the subscribers, and ascertain whether the transaction is genuine, or these are bogus entries of name-lenders.
3. If the enquiries and investigations reveal that the identity of the creditors to be dubious or doubtful, or lack credit-worthiness, then the genuineness of the transaction would not be established and the taxpayer would have failed to discharge the primary onus under Section 68.

Applying these principle to the facts of the instant case, the Supreme Court noted that the AO has made a detailed independent enquiry and found that some of the investor companies were non-existent and did not have an office at the address supplied by the Taxpayer. Further, the investors, despite having negligible taxable income had invested in the Taxpayer, at a very high price of INR 190 per share for which no explanation had been forthcoming from the investors.

The Supreme Court held that the mere mention of the income tax file number of a shareholder does not discharge a company from the initial onus put on it by Section 68 of the ITA and the lower courts should have given due consideration to the field enquiries made by the AO. The onus on the Taxpayer was to establish the credit worthiness of the investor companies which it failed to do and hence, the Supreme Court allowed the addition of the share capital/ premium to the income of the Taxpayer.

THE INCOME TAX OFFICER-6(2)(1), MUMBAI V. M/S. CHIRIPAL POLY FILMS LTD.[10]

Chiripal Poly Films Ltd ("**CPFL**"), a closely held company proposed to set-up a project at Vraj Integrated Textile Park Ltd., Bidaj Village, Kheda District in Gujarat for manufacture of Biaxially Oriented Polypropylene (BOPP Film) and also expand a second line of BOPP films. CPFL was expected to derive substantial revenues from the said projects.

CPFL entered into share holder agreement dated March 15, 2011 with Orange Mauritius Investment Ltd. ("**Orange**"), a Mauritius resident company, whereby Orange agreed to subscribe to 1.98 lakh shares of CPFL of INR 10 each at a premium of INR 990 per share. The allotment of equity shares was to be made by CPFL to the investor on receipt of full payment of INR 19.8 crores. CPFL received share application money amounting to INR 4.47 Crores (approx.) from Orange on March 25, 2011. This share money was pending allotment as on March 31, 2011 in the balance sheet.

The AO alleged that the authorized share capital of CPFL was only INR 3 crore out of which CPFL had already issued share capital worth INR 1.79 Crores (approx.) by March 31, 2011 and subsequently also CPFL did not increase its authorized share capital or file any application for increasing the authorized share capital. The AO also questioned the high amount of share premium of INR 990 per share given the lower fair market value of CPFL and added INR 23.5 Crores (approx.) to the income of CPFL under Section 68 of the ITA. This addition was rejected by the CIT(A) and the AO preferred an appeal before the ITAT against this decision of the CIT(A).

During the year under consideration, the CPFL received fund of INR 4.47 Crores (approx.) on March 25, 2011 out of total investment of INR 19.80 crores. The balance funds were remitted by the investor in subsequent years, which was already mentioned in Form FCGPR filed by CPFL with the RBI. The ITAT held that under the ITA, there was no requirement for increasing the share capital for allotment of shares of 1.98 lakhs to Orange and any case the shares were ultimately allotted later during the previous year relevant to next assessment year. Further, under the provisions of section 68 of the ITA, the only requirement is that the transaction should be genuine, identity of the party should be established and credit worthiness of the party should be proved and hence this contention of the AO was held to be irrelevant.

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The ITAT referred to the judgment of the Hon'ble Bombay High Court in the case of *CIT v. Green Infra Ltd*[11] where it was held that genuineness of the transaction is proved once the entire transaction is recorded in the books of the taxpayer and the transaction has taken place through banking channels. The Hon'ble High Court also specifically held that it is a prerogative of the board of directors of a company to decide the premium amount and it is the wisdom of the shareholders whether they want to subscribe to such a heavy premium. In the absence of any bar from any legislated law of the land, it Is not open to the revenue authorities to question the charging of such of huge premium.

SECTION 56(2)(VIIB) NOT TO BE RENDERED REDUNDANT:

The ITAT observed that Section 56(2)(viib) had been inserted in the ITA to address situations where the valuation for charging premium in case of a share allotment is not accepted by the tax authorities. In view of the same, the ITAT held that allowing Section 68 to be invoked in such situations will render the provisions of section 56(2)(viib) of the ITA redundant and nugatory which cannot be the intention of the legislature.

The AO had also relied on the provisions of Section 56(2)(viib) of the ITA for treating the share premium as income of CPFL. The ITAT observed that since Section 56(2)(viib) was inserted by way of the Finance Act, 2013 with effect from April 1, 2013, i.e., from A. Y. 2013-14 and not earlier Assessment Years since the amendment is prospective and not retrospective. Hence, it held that on the issue of share premium, the provisions of section 56(2) (viib) of the ITA cannot be applied for making addition even under section 68 of the ITA.

NO POWER TO CALL FOR VALUATION UNDER SECTION 68:

The ITAT considered the provisions of Section 142 of the ITAT which gives power to the AO to make a reference to the Valuation Officer and noted that this section does not cover section 68 of the ITA within its ambit. On this basis, the ITAT concluded that the legislature did not intend to give powers to the tax authorities to require any sort of valuation for the purpose of section 68 of the ITA.

The ITAT perused the documents submitted by CPFL regarding compliance with RBI guidelines (including the Form FCGPR filed with RBI) and concluded that comprehensive documentary evidences have been placed on record by the CPFL to establish the nature and the genuineness of the transaction and the source of the money received after fulfilling all the mandatory requirements of RBI. In view of the same, the onus placed under it by Section 68 stood discharged and it was not open to the AO to add the share premium to the income of CPFL.

M/S. ABHIJEET ENTERPRISE LTD V. INCOME TAX OFFICER, WD-2(2), KOLKATA[12]

M/s. Abhijeet Enterprise Ltd. is a private limited company ("**AEL**") with almost all its shares (more than 95%) being held by M/s. Abhijit Projects Ltd. ("**APL**"). The shares of APL in turn are held by M/s. Abhijeet Ventures Ltd. ("**AVL**"). APL approached certain banks and financial institutions for availing credit facilities in view of an acute financial crunch. The creditors agreed to lend to APL subject to APL off-loading certain illiquid investments in its group companies to its subsidiaries to ensure that its balance sheet majorly reflects business assets in steel and aviation. The creditors also insisted on this restructuring to ensure that the credit/loans given to APL were not deployed towards these investments but would rather be utilized towards these business assets.

In view of this condition put forth by the creditors, a group restructuring exercise was conducted pursuant to which the investments held by APL were transferred to AEL on credit and the amount payable to APL was reflected in the AEL's financial statements under the head "Other Payables". The AO sought to add the amount so credited to the income of AEL by invoking Section 68 of the ITA which was confirmed by the CIT(A). AEL preferred an appeal against this order of the CIT(A) before the ITAT.

The main question before the ITAT was whether Section 68 of the ITA could also be made applicable to a situation where there was no actual receipt of cash but simply an outstanding liability on a company to pay. It referred to the judgment of the Supreme Court in the case of *H.H. Sri Rama Verma v. CIT*,[13] the judgment of the Calcutta High Court (the jurisdictional High Court in the instant case) in the case of *Jatia Investment Co v. CIT*,[14] and that of the Madras High Court in V.*R. Global Energy Pvt. Ltd. v. ITO*,[15] and held that the provisions of Section 68 of the ITA may not be applied to an outstanding liability on a company to make payment to another.

The ITAT remanded the file back to the AO with a direction that if it is found that AEL has not received any money/cash from its holding company for the relevant assessment year, Section 68 of the ITA cannot be applied and the addition made by the AO should be deleted. However, if any element of money/cash is found to have been received by AEL from its holding company, then the AO should ascertain whether AEL is able to discharge the onus put on it by Section 68 by considering the three essential ingredients and make any addition if AEL is unable to discharge such onus.

CONCLUSION:

The judgment of the Hon'ble Supreme Court in the case of *NRA Iron & Steel* (supra) has led to a lot of concern amongst taxpayers. There is an apprehension that while the tax department is allaying the concerns of taxpayers with respect to the angel tax controversy, another provision of the ITA may result in adversarial tax litigation in cases involving share subscription at premium. However, what need to be noted is that the judgement of the Supreme Court was delivered in the context of certain specific facts and circumstances. Many of the investors/ subscribers of shares in this case were companies which were found to be non-existent and were unable to justify how they had invested at such a premium despite having negligible taxable income as per their income tax returns. No substantive reply was forthcoming regarding the source of the funds used to make the investment. These specific facts resulted in the Supreme Court ruling against the Taxpayer wherein it also reaffirmed some already established principles regarding the essential ingredients for the use of Section 68 of the ITA.

In view of the same, the ruling of the ITAT in the case of *M/s. Chiripal Poly Films Ltd.* (supra) coming after the judgment of the Supreme Court should provide some comfort to stakeholders as this case clearly demonstrates that as long as a taxpayer is able to demonstrate the genuineness of a transaction by establishing the identity of the investors and their credit worthiness, the courts should consider them as having discharged the onus under Section 68 of the ITA. Similarly, the judgment of the ITAT in the case of *M/s. Abhijeet Enterprise Ltd.* (supra) also demonstrates that the courts have not done away with the long-established precedents around Section 68 and these judgements should still put a check on any potential misuse of this provisions by the tax authorities.

Thus, given the established jurisprudence around this provision and the peculiar set of facts involved in the judgment in *NRA Iron & Steel* (supra), Section 68 of the ITA is unlikely to become another flashpoint of high-profile tax controversy in the manner of the angel tax provisions and genuine taxpayers should not be worried of any adverse consequence resulting from this judgment.

– Shashwat Sharma & Ashish Sodhani
You can direct your queries or comments to the authors

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[1] **Cash credits.**
68. Where any sum is found credited in the books of an assessee maintained for any previous year, and the assessee offers no explanation about the nature and source thereof or the explanation offered by him is not, in the opinion of the Assessing Officer, satisfactory, the sum so credited may be charged to income-tax as the income of the assessee of that previous year:
Provided that where the assessee is a company (not being a company in which the public are substantially interested), and the sum so credited consists of share application money, share capital, share premium or any such amount by whatever name called, any explanation offered by such assessee-company shall be deemed to be not satisfactory, unless—
(*a*) the person, being a resident in whose name such credit is recorded in the books of such company also offers an explanation about the nature and source of such sum so credited; and
(*b*) such explanation in the opinion of the Assessing Officer aforesaid has been found to be satisfactory:
Provided further that nothing contained in the first proviso shall apply if the person, in whose name the sum referred to therein is recorded, is a venture capital fund or a venture capital company as referred to in clause (*23FB*) of section 10.

[2] [2019] 103 taxmann.com 48 (SC)

[3] ITA No.2671/Mum/2016

[4] ITA No. 308/Kol/2017

[5] Supra note 2.

[6] (2008) 299 ITR 268 (Delhi)

[7] 291 ITR 278

[8] [2003] 264 ITR 254 (Gau.)

[9] *Kale Khan Mohammad Hanif* v. *CIT* [1963] 50 ITR 1 (SC)*; Roshan Di Hatti v. CIT* [1977] 107 ITR (SC)

[10] Supra note 3.

[11] [2017] 392 ITR 7 (Bombay)

[12] Supra note 4.

[13] 187 ITR 308;

[14] 306 ITR 718)

[15] 96 taxmann.com 647
