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UNAUDITED BALANCE SHEET SUFFICIENT FOR TAX VALUATION PURPOSES

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BACKGROUND

The Chandigarh bench of the Income Tax Appellate Tribunal (ITAT) in its recent decision in the case of *Electra Paper and Board Pvt Ltd v. ITO [ITA NO.222/Chd./2021*] has held that for computing the fair market value (FMV) of the shares of a company, for the purposes of section 56(2)(viib) of the Income-tax Act, 1961 (IT Act), the unaudited balance sheet drawn as on the valuation date should be sufficient, if such unaudited balance sheet is subsequently audited with there being no difference in the audited and unaudited numbers.

As per section 56(2)(viib) of the IT Act, if a closely held company issues shares to residents at premium in excess of the FMV of its shares, then such excess share premium is taxable in the hands of the company (generally referred to as "Angel Tax"). For the purposes of determination of such FMV, the valuation rules (Rule 11U and Rule 11UA of the Income Tax Rules 1962 (IT Rules)) define the term 'balance sheet' as - the balance sheet of the company as drawn up on the valuation date (i.e., on the date of issue of shares) which has been audited by the auditor of the company appointed under the Companies Act, and if no balance sheet is drawn up on the valuation date, then the balance sheet drawn up as on a date immediately preceding the valuation date which has been approved and adopted in the annual general meeting of the company.

BRIEF FACTS

- The assessee, a private limited company (Taxpayer) issued shares on 31 March 2016 (Issuance Date) at INR 20, being in compliance with the FMV of such shares derived basis the *unaudited balance sheet* of the Taxpayer drawn on the Issuance Date.

- Subsequently, during the assessment proceedings for the financial year (FY) 2016-17, the tax officer held that as the balance sheet on the Issuance Date was unaudited, the last audited balance sheet of the Taxpayer as of 31 March 2015, should have been used for the purpose of determining the FMV of Taxpayer's shares for the purposes of Angel Tax provisions. On this basis, the FMV of Taxpayer's shares was determined as INR 17.32. Since the issue price was higher than the said FMV, the premium to FMV i.e., INR 2.68 per share (the difference between 20 and 17.32) aggregating to INR 8,55,590 was taxed as income of the Taxpayer under the Angel Tax provisions of the IT Act.

- In appeal before the first appellate authority, the addition made by the tax officer was upheld. Thus, the Taxpayer filed an appeal before the Chandigarh bench of the ITAT.

RULING

The ITAT referred to the definition of 'balance sheet' under Rule 11UA of IT Rules for ascertaining as to which balance sheet should be referred for determining the FMV of shares for the purposes of Angel Tax provisions. Accordingly the ITAT noted that the relevant balance sheet would either be: (a) the balance sheet as drawn up on the valuation date and which has been audited by auditor; or (b) if a balance sheet is not drawn up on the valuation date, then such balance-sheet drawn on a date immediately preceding the valuation date and audited by the auditors.

The ITAT observed that, in the instant case, given that a balance sheet was already drawn up on the Issuance Date, the case of the Taxpayer fell within part (a) of the definition of 'balance sheet'. In so far as the requirement for such balance sheet to be audited, the ITAT held that there is no requirement under part (a) of the definition for such drawn up balance sheet on the Issuance Date to also be audited as on the same date and held that it would be sufficient if it is subsequently audited.

The ITAT noted that, in the case of the Taxpayer, the balance-sheet which was drawn up on the Issuance Date was subsequently audited and there were no differences between the unaudited and audited position. Thus, the FMV derived by the Taxpayer basis its unaudited balance sheet, as drawn up on the Issuance Date, was held by the ITAT to be in compliance with the Angel Tax Provisions.

Accordingly, the appeal of the Taxpayer was allowed and the addition made by the tax authorities was set aside.

COMMENTS

Finalisation of a company's accounts followed by audit is a lengthy procedure – it entails considerable efforts, including exercise of professional judgment by the company's management as well as its auditors. Therefore, it is practically impossible for companies to finalise their accounts and have them audited immediately on the same date. The ITAT has acknowledged these practical considerations and provided relief to the Taxpayer.

Notably, similar valuation requirements apply in relation to transfer of shares under section 50CA and 56(2)(x) of the IT Act for the transferor as well as the recipient of shares. As per these provisions, if shares are transferred at a value lower than their the FMV, then there could be tax implications for the transferor as well as the recipient on a deeming basis. For the purposes of determining the FMV of shares in respect of the aforesaid provisions, the valuation rules define 'balance sheet' as – the balance sheet of the company as drawn up on the valuation date and which has been audited by the auditor of the company appointed under the applicable law in force relating to companies. Thus, this ruling should provide important guidance in relation to such transactions as well and so long as there is no material difference between audited and unaudited financials, unaudited financials drawn up on the valuation date (being the date of share transfer as per applicable rules), audited subsequently, should be considered as sufficient compliance.

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