IN THE INCOME TAX APPELLATE TRIBUNAL

"C" BENCH, MUMBAI

BEFORE SHRI G.S. PANNU, PRESIDENT AND

SHRI SANDEEP SINGH KARHAIL, JUDICIAL MEMBER

ITA no.7356/Mum./2019
(Assessment Year : 2011–12)

Asstt. Commissioner of Income Tax
Circle–15(1)(1), Mumbai ……. Appellant

v/s

M/s. Privi Speciality Chemicals Ltd.
(Erstwhile Privi Organics Ltd.)
A–71, TTC, Privi House .....Respondent
Thane Belapur Road, Koparkhairne
Navi Mumbai 400 709 PAN–AAACH5113Q

Assessee by : Shri Sanjay Parikh
Revenue by : Shri K.C. Salvamani

Date of Hearing – 05/12/2022	Date of Order – 24/01/2023

O R D E R

PER BENCH

The captioned appeal has been filed by the Revenue challenging the impugned order dated 11/09/2019, passed under section 250 of the Income Tax Act, 1961 ('*the Act*') by the learned Commissioner of Income Tax (Appeals)–9, Mumbai, ['*learned CIT(A)*'], for the assessment year 2011–12.

2. In its appeal, the assessee has raised the following grounds:–

"1. Whether on the facts and in the circumstances of the case and in law, the Ld.CIT(A) erred in directing the AO to delete the addition of Short Term capital Gains arising on account of premium received by assessee for transferring Redeemable Cumulative Convertible Preference Share and Fully Compulsory Convertible Preference Shares to equity shares during the year.

2. Whether on the facts and in the circumstances of the case and in law, the Ld.CIT(A) erred in directing the AO to delete the addition of Rs. 1,16,64,751/- as it is unrealized foreign exchange gain even though the same is accounted for by the assessee as per the mercantile system of accounting.

3. The appellant craves leave to amend or alter any ground or add new ground which may be necessary."

3. The issue arising in ground No. 1, raised in Revenue's appeal, is pertaining to the addition on account of premium received by the assessee as short-term capital gains.

4. The brief facts of the case pertaining to this issue are: The assessee is a private limited company and is engaged in the business of manufacturing, trading, and export of aroma chemicals. For the year under consideration, the assessee e-filed its return of income on 10/12/2009 declaring a total loss of Rs.1,39,84,692. The assessee company originally issued fully compulsory convertible preference shares (*'FCCPS'*) and Redeemable Cumulative Convertible Preference Shares (*'RCCPS'*) at a face value of Rs. 10,000 each to M/s Avigo Venture Investments Ltd and M/s Avigo Trustee Company Private Ltd. Thereafter, both the preference shareholders transferred these preference shares to M/s Satguru Construction. During the year under consideration, all the redeemable preference shares were redeemed by the assessee by issuing 19,29,953 equity shares at a face value of Rs. 10 each and crediting Rs. 22,06,90,470 in the Reserves and Surplus under the Security Premium Account. Accordingly, during the assessment proceedings, the assessee was asked to show cause as to why the amount credited as a security premium in the Reserves and Surplus be not treated as a capital gain on redemption of

preference shares. In response thereto, the assessee submitted that the transfer on the conversion of preference shares into equity shares is in the hands of the shareholder i.e. M/s Satguru Constructions, and not in the hands of the assessee. The assessee further submitted that even in the case of a buyback of shares, the capital gains and transfer in such a case, only arise in the hands of the shareholder and not in the hands of the company. The Assessing Officer (*'AO'*) vide order dated 10/02/2014 passed under section 143(3) of the Act did not agree with the submissions of the assessee and by placing reliance upon the decision of Hon'ble Gujarat High Court in Anarkali Sarabhai vs CIT (1982) 138 ITR 437 (Guj.) held that there was an asset which was transferred and as gain has been accrued to the assessee, therefore the same is assessed as capital gains in the hands of the assessee. The AO treated the amount of Rs.22,06,91,000 credited to the Security Premium Account as short-term capital gains and added the same to the total income of the assessee.

5. The learned CIT(A) vide impugned order allowed the appeal filed by the assessee on this issue and held that the transfer in respect of preference shares is in the hand of the shareholder i.e. M/s Satguru Constructions. The relevant findings of the learned CIT(A), vide impugned order, in respect of this issue are as under:

> *"4.3.5 It is clear from the facts that the payment of Rs.22.799 crores was received by the appellant in F.Y. 2007-08 on account of FCCPS and RCCPS from two entities. The preference shares were issued with an inherent condition for conversion into equity shares at a fewer rate as per a pre-decided mechanism limited to profit after taxes (PAT) as on 31.03.2010. If, there was any doubt about the genuineness of the amounts received then it should have been probed in the assessment for A.Y. 2008-09 in the case of the appellant. As far as the conversion of preference shares into equity shares is concerned, it is considered as transfer as per the decision of Hon'ble*

Supreme Court in the case of Anarkali Sarabhai, 224 ITR 422. In fact, the AO has also cited this decision while supporting his preposition. However, it needs to be noted that the transfer in respect of the preference shares is in the hand of shareholder that is M/s. Satguru Constructions. Even if, the conversion is considered as buyback of shares by the appellant, the buyback was not taxable in the hands of the appellant company for A.Y. 2011-12. It appears that the AO misread the facts of the case and considered the transaction as that of capital gains even after admitting in the same breath that the appellant company had a liability to pay on redeeming the preference shares. At the best, the AO could have challenged the charging of share premium at substantially high rate. However, since the provisions of section 56(2)(7b) are applicable only after A.Y. 2013-14, there was also no scope for addition on that account. Thus, in view of the facts of the case, the conclusion drawn by the AO while treating the conversion of preference shares into equity shares at a premium as capital gains is erroneous and do not have any legs to stand. Therefore, the addition of Rs.22,06,91,000/- is deleted. The ground of appeal is allowed."

Being aggrieved, the Revenue is in appeal before us.

6. During the hearing, the learned Departmental Representative ('*learned DR*') by vehemently relying upon the order passed by the AO submitted that the amount credited in the Security Premium Account on the conversion of preference shares into equity shares is the gain arising in the hands of the assessee, which is taxable. The learned DR also placed reliance upon the decision of the Hon'ble Supreme Court in Kartikeya V. Sarabhai vs CIT, [1997] 228 ITR 163 (SC).

7. On the other hand, the learned Authorised Representative ('*learned AR*') by placing reliance upon the impugned order passed by the learned CIT(A) submitted that the transaction of conversion of preference shares into equity shares is in the hands of the shareholder and therefore the addition has been rightly deleted by the learned CIT(A).

8. We have considered the rival submissions and perused the material available on record. In the present case, 11,999 RCCPS were issued by the assessee at a face value of Rs.10,000, in the financial year 2006-07 and

12,000 FCCPS were issued at a face value of Rs.10,000, in the financial year 2007-08. The preference shares were issued with an inherent condition for conversion into equity shares. Both these preference shares were transferred by the original preference shareholders to M/s Satguru Construction vide transfer deed dated 28/02/2011. In the year under consideration, all the preference shares were redeemed by the company by issuing equity shares to M/s Satguru Construction without the payment of any further consideration. The AO treated the amount credited to the Reserves and Surplus under the Security Premium Account as capital gains in the hands of the company. The AO in support of its conclusion placed reliance upon the decision of the Hon'ble Gujarat High Court in Anarkali Sarabhai (supra). We find that in the aforesaid decision the following issue came up for consideration before the Hon'ble Gujarat High Court:

> *"Whether, on the facts and in the circumstances of the case, the Tribunal was justified in holding that the assessee was liable to pay tax in respect of capital gains on receipt of the amount equal to the face value of the preference shares of Universal Corporation (P.) Ltd. on the company redeeming its preference shares?"*

9. The Hon'ble Gujarat High Court decided the aforesaid issue by observing as under:

> *"18. In the light of the above discussion, we have no doubt that when the company redeemed preference shares held by the assessee, there was 'transfer' within the meaning of section 2(47) of the Act which would attract section 45. In our opinion, the Tribunal was justified in holding that the assessee was liable to pay tax in respect of the capital gains on receipt of the amount equal to the face value of the preference shares of the company, held by her. We, therefore, answer Question No. 1 in the affirmative and against the assessee."*

10. Thus, from the above, it is evident that the conclusion of the Hon'ble High Court that redemption of preference shares will result in transfer within the meaning of section 2(47) of the Act was held to be in the hands of the

shareholder, which in the present case is M/s Satguru Constructions. The Hon'ble Supreme Court in Anarkali Sarabhai vs CIT, in [1997] 224 ITR 422 (SC), upheld the aforesaid findings of the Hon'ble Gujarat High Court. Further, the aforesaid decision of the Hon'ble Gujarat High Court was followed in Kartikeya V. Sarabhai vs CIT [1982] 128 ITR 425 (Guj.), which was affirmed by the Hon'ble Supreme Court in Kartikeya V. Sarabhai vs CIT, [1997] 228 ITR 163 (SC), relied upon by the learned DR. In the present case, it is to be appreciated that the conversion of preference shares into equity shares is in the hands of the shareholder, i.e. M/s Satguru Constructions. Thus, gain, if any, arising from such a conversion will only be taxable in the hands of the shareholder. Therefore, in view of the above, we find no infirmity in the findings of the learned CIT(A) on this issue. As a result, ground No. 1 raised by the Revenue is dismissed.

11. The issue arising in ground No. 2, raised in Revenue's appeal, is pertaining to the addition on account of unrealised foreign exchange gain.

12. The brief facts of the case pertaining to this issue are: During the year under consideration, the assessee had a gain on foreign exchange valuation amounting to Rs.1,16,64,751, on account of loan transactions with a foreign entity. During the assessment proceedings, the assessee was asked to show cause as to why the amount of such loan which was not repaid and remained as such as on 31st March of the previous year be not added back to the total income of the assessee. In reply thereto, the assessee submitted that as per Accounting Standard 11, the assessee was required to reinstate its accounts for foreign currency difference on account of pending foreign exchange

liabilities and assets. Thus, the same resulted in unrealised gain or loss at the year-end at the prevailing rate on the last date of the accounting year. The assessee further submitted that in the earlier years, due to the reinstatement of accounts, there was a loss and the same was neither claimed by the assessee nor the same was allowed to it in any of the earlier years. The assessee also submitted that the unrealised gain of Rs.1,16,64,751, consists of the reinstatement of a term loan taken in foreign currency for the acquisition of fixed assets and as per section 43A the cost of fixed assets is required to be increased or decreased by the amount of foreign exchange gain or loss on payment basis. The AO vide order passed under section 143(3) did not agree with the submissions of the assessee and added the gain on account of foreign exchange valuation to the total income of the assessee by observing as under:

> *"4.3 the assessee's explanation was examined but are not tenable and hence not accepted. The facts of Woodward Governor India P. Ltd. is not applicable to the case of the assessee for the following reasons:*
>
> *a. The transactions were not completed as on 31st March and this is only a contingent liability;*
>
> *b. The loss accrued on loan transactions which is on capital account and therefore is not a revenue deduction which can be claimed under any provisions of I.T. Act.*
>
> *4.4 Therefore, an amount of Rs.1,16,64,751/– is disallowed and added to the total income of the assessee."*

13. The learned CIT(A), vide impugned order, allowed the appeal filed by the assessee on this issue by observing as under:

> *"4.4.2 I have verified the facts of the case. As per the amended provisions of section 43A of the Act, it is expressly provided that the increase or decrease in the liability of a tax-payer as expressed in indian currency for making payment towards the whole or part of the cost of the asset for repayment of the whole or a part of the moneys borrowed by him for any person shall be added or reduced from the actual cost of the asset only on the actual payment of loan. The CBDT has also specified in instruction no. 3/2010 that loss on account of mark to market cannot be considered as an allowable deduction where no sale or settlement has actually taken place. I have also perused the decision of Hon'ble Supreme Court in the case of CIT vs. Woodward Governor India Pvt.*

Ltd., 312 ITR 254 wherein the Hon'ble Court has referred to the provisions of section 43A and held that after the amendment of section 43A with effect from A.Y. 13-14, loans on account of fluctuation of foreign exchange would be required to be adjusted only when actual losses were suffered.

4.4.3 In the case under hand, it is an undisputed fact that the cost of the capital asset for which term 'loan' in foreign exchange was obtained was not fully paid during the year under consideration. In such situation as per the amended provisions of section 43A of the Act, there was no question of considering the unrealised gain on account of foreign exchange fluctuation as income of the appellant. The appellant is also following a consistent practice of not accounting for either gain or loss from foreign exchange fluctuation in respect of loans taken for assets for which the payments are not fully made by the appellant. Thus, in view of the bare provisions of the amended section 43A of the Act, instruction no.3/2010 of CBDT and the judgements of Hon'ble Supreme Court in the case of CIT vs. Woorward Governor India Pvt. Ltd., the decision of the AO to consider unrealised gain of Rs.1,16,64,751/- as income of the appellant was not justifiable. Therefore, the addition of Rs.1,16,64,751/- is deleted. The ground of appeal is allowed."

Being aggrieved, the Revenue is in appeal before us.

14. During the hearing, the learned DR vehemently relied upon the order passed by the AO. On the other hand, the learned AR reiterated the submissions made before the lower authorities.

15. We have considered the rival submissions and perused the material available on record. During the year under consideration, reinstatement of accounts, as per Accounting Standard 11, by the assessee resulted in unrealised gain at the end of the year. As per the assessee, the said gain was on account of a foreign exchange loan taken for the purchase of fixed assets, which were reinstated at the year-end by considering the year-end rate of foreign exchange. We find that the AO, vide assessment order, made the impugned addition by considering it to be a loss accrued on a loan transaction, which is on a capital account. From the perusal of the financial statement of the assessee, forming part of the paper book, we find that during the year, the assessee has only accounted for gain arising from foreign exchange

fluctuation. Therefore, the finding of the AO that loss on foreign exchange valuation was claimed as a deduction is contrary to the material available on record. Further, as per the provisions of section 43A of the Act, as amended by Finance Act 2002, w.e.f. 01/04/2003, the actual payment of the decreased /enhanced liability, due to a change in the rate of exchange subsequent to the acquisition of the asset in foreign currency, is a condition precedent for making adjustment in the cost of the fixed asset. Since the foreign exchange fluctuation gain, in the present case, is only due to the reinstatement of the accounts at the end of the year by considering the year-end rate of exchange, therefore, the same can neither be considered for computing the cost of the fixed assets for which loan was availed in foreign currency, nor any question arises for considering the said gain as income of the assessee for the year under consideration. Therefore, we find no infirmity in the impugned order passed by the learned CIT(A) on this issue deleting the addition made by the AO. As a result, ground No. 2 raised in Revenue's appeal is dismissed.

16. In the result, the appeal by the Revenue is dismissed.

Order pronounced in the open Court on 24/01/2023.

Sd/-	**Sd/-**
G.S. PANNU	**SANDEEP SINGH KARHAIL**
PRESIDENT	**JUDICIAL MEMBER**

MUMBAI, DATED: 24/01/2023

Copy of the order forwarded to:

(1) The Assessee;

(2) The Revenue;

(3) The CIT(A);

(4) The CIT, Mumbai City concerned;

(5) The DR, ITAT, Mumbai;

(6) Guard file.

By Order

Pradeep J. Chowdhury
Sr. Private Secretary

Assistant Registrar
ITAT, Mumbai