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Option money received for grant of right of first refusal is a capital receipt: Delhi ITAT

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Summary

The Delhi Bench of the Income-tax Appellate Tribunal (ITAT), in a recent decision[1], analysed the nature of 'option money' received annually by the taxpayer for granting a 'right of first refusal to stake purchase' to its joint venture partner, where the option money was to be adjusted against the sale consideration of shares at the time of sale to a joint venture partner. The ITAT held that such amount is a capital receipt and thus not liable to tax under the Act.

Facts of the case

- A Joint Venture (JV) agreement was entered into between M/s Commercial Union International Holdings Ltd. (JV partner), a foreign company and Dabur Invest Corp. (Dabur), a partnership firm, in 2001 to co-promote a JV company proposed to be established in India for the purpose of setting up and carrying on the business of insurance, pension and long-term savings.
- Dabur subscribed to 74% of the total paid up equity capital of JV company and the JV partner subscribed to the remaining 26%, which was the maximum foreign investment permitted in the insurance sector at that time.
- As per the JV agreement, in the event the government increases the maximum foreign investment limit in the insurance sector, the JV partner shall have the right to purchase stake from Dabur up to such increased limit. The JV agreement also provided that the parties were allowed to sell their stake to any outsider only after the approval by other party.

[1] Dabur Invest Corp vs. Pr. CIT [ITA No. 1763/DEL/2018 & ITA No. 1764/DEL/2018]

- As per the JV agreement, the JV partner was required to pay a refundable option price annually to the taxpayer against the right of stake purchase equal to 20% of the investment made by the taxpayer in JV company.
- The taxpayer recognised the option money as an advance in its books of account, to be subsequently adjusted at the time of transfer of shares to the JV partner.
- During FY 2016-17, the government increased the maximum foreign investment limit in the insurance sector from 26% to 49% upon which the JV partner exercised its right to purchase an additional 23% stake from the taxpayer.
- The tax officer was satisfied with the practice adopted by the taxpayer and completed the assessment for Assessment Years (AY) 2005-06, 2006-07, 2008-09, 2011-12, 2013-14 and 2014-15 without any adverse inference. The tax officer took a view that capital gains, if any, would arise in the year of divestment of holding in favour of the JV partner.
- The Commissioner of Income-tax (CIT), on a review[2] of the tax officer's order, held that the orders for AYs 2013-14 and 2014-15 are erroneous and prejudicial to the interest of the revenue and directed the tax officer to complete such assessments afresh as per the provisions of the Act.
- Aggrieved, taxpayer filed an appeal before the Delhi ITAT.

Revenue's contention

- Option price received annually by the taxpayer was practically not refundable as per the JV agreement notwithstanding the market value of shares at the time of sale.
- The taxpayer is a dummy stakeholder and acted as a financer to the JV partner. Further, the taxpayer received a fixed return of 20% on its investment annually, akin to interest, and thus option money received was business income of the taxpayer. Reliance was placed on a Mumbai ITAT decision[3].
- The CEO of the JV company was from the JV partner, though the majority shareholding was with the taxpayer. The day-to-day control was with the JV partner, and thus held that the whole arrangement is a sham transaction.

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[2] Section 263 of the Act
[3] Mahindra Telecommunications vs. ITO (ITA No. 2832/Mum/2012)

- Investment in the shares of the JV company was the business of the taxpayer, and thus the option price received annually as well as return at the time of divestment of shares was the business income of the taxpayer.

ITAT observation and ruling

- The JV agreement was approved by the Insurance Regulatory and Development Authority (IRDA) as well as by the Reserve Bank of India (RBI). The manner of the payment, as well as the quantum of refundable option price, was described in the JV agreement. Therefore, the taxpayer cannot be termed as a 'dummy stake holder'.
- The JV agreement was not made to carry out any business transaction but to co-promote the JV company. The investment in JV company was not the taxpayer's business but an investment as capital contribution. Both the parties were restricted by the agreement to sell their stake to an outsider.
- The option price has to be taken into account for working out the selling price of the stake and thus is the capital receipt. The liability towards income-tax, if any, would arise in the year in which the transfer of shares took place.
- It is the prerogative of the board to appoint its CEO to its run day to day business. CIT cannot decide how the taxpayer should do its business.
- The ITAT observed that the tax officer has formed his view after examining the JV agreement and the notes to accounts. Where the tax officer has taken a possible view, it cannot be held as erroneous and prejudicial to the interest of the revenue because of difference in opinions[4]. Accordingly, the ITAT restored the tax officer's order for the subject AYs.

Our comments

The ITAT has reaffirmed the established principle that the motive for which the payment is made is important. Whether the amount is large or is periodic does not decide the capital or revenue in nature of a receipt. Further, this ruling is based on peculiar facts of the JV arrangement under consideration and due care should be exercised in applying the principles to other arrangements.

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4 CIT vs. Sunbeam Auto Ltd. [2010] 189 Taxman 436 (Delhi)

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