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Provisions of section 56(2)(vii)(c) are not applicable to issue of additional shares on a pro rata basis

In brief

In the recent case of Sudhir Menon HUF[1], the Mumbai Bench of Income-tax Appellate Tribunal (the Tribunal) held that the provisions of section 56(2)(vii)(c) of the Income-tax Act, 1961 (the Act) were not applicable in the case of issue of additional shares on a *pro rata* basis to the existing shareholders.

Facts

- The taxpayer was a Hindu Undivided Family (HUF) that held 15,000 shares of Dorf Ketal Chemicals Private Limited (DKCPL). The remaining shares were held by the family of the *Karta* of the taxpayer-HUF.
- During 2009-10, DKCPL offered an additional 3,13,624 shares to the taxpayer. It subscribed to, and was allotted, 1,94,000 shares at the face value INR 100 each.
- A similar offer was made to other shareholders who, in addition to their offer, subscribed to the remaining shares not subscribed to by the taxpayer-HUF, i.e., 1,19,624 shares.
- The book value of the shares as at 31 March 2009 was INR 1,538 per share.
- The tax officer treated the difference, INR 1,438 per share (INR 1,538 less INR 100), as inadequate consideration under section 56(2)(vii)(c) of the Act and proceeded to tax INR 27 lakhs as additional income in the hands of the taxpayer.

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[1] Sudhir Menon HUF *v.* ACIT [TS-146-ITAT-2014(Mum)]

Issue before the Tribunal

Whether it was valid in law to assess the difference between the value of the shares allotted to the taxpayer and the consideration paid by it, as the taxpayer's income?

Revenue's contentions

- The taxpayer was in receipt of additional shares at the face value of INR 100 per share. These additional shares fell within the meaning of 'shares and securities' in the Explanation to section 56(2)(vii) of the Act.
- The book value of the shares of DKCPL as on 31 March 2009 was INR 1,538 per share. This value had to be adopted as the Fair Market Value (FMV) under the applicable Rule 11U and 11UA of Income-tax Rules, 1962.
- Hence, the excess of the FMV over the consideration paid, i.e., INR 1,458 per share or in aggregate INR 27 lakhs, had to be considered as the extent of the inadequate consideration towards the acquisition of additional shares and hence, exigible to tax in the taxpayer's hands.

Taxpayer's contentions

- The taxpayer contended that the 'right to acquire additional shares (at a concessional rate) in the company' was not a property within the meaning of the Explanation to section 56(2)(vii) of the Act. While the right to acquire additional shares came into existence at the time the Board resolution was passed, the shares came into existence only at the time of allotment of shares. The event of receipt of property, so far the taxpayer was concerned, was the point of time when it obtained the right to acquire additional shares, and not the allotment of shares. Hence, the provisions of section 56(2)(vii)(c) of the Act were never intended to cover a transaction in the nature of a rights issue.
- If section 56(2)(vii)(c) of the Act was made applicable to a rights issue, then a similar treatment may be required to be attributed to bonus shares also, which may lead to absurd results.
- In the present case, there was neither a transfer in favour of the taxpayer, nor was the issuer- company the owner of the shares. The section which required "receipt from any person or persons" will not *per se* apply in the case of the taxpayer, as the company issuing the shares was not the owner of the shares. As allotment of shares was not a transfer of capital asset and the company issuing the shares was not the owner of the shares, the transaction could not be considered as a "receipt from any person or persons".
- Furthermore, the taxpayer contended that the right to acquire additional shares arose out of the existing shareholding, and that the transaction under consideration could be compared to a demerger where the shareholders of the demerged company acquired shares in the resulting company based on their shareholding in the demerged company.

Tribunal's ruling

- Property as contemplated under section 56(2)(vii)(c) of the Act included 'shares and securities' and it was held that the property under reference, i.e., rights shares, qualified as 'property' under section 56(2)(vii)(c) of the Act, ruling out the taxpayer's contention that the right to acquire additional shares was not property in this case.
- The Tribunal observed that though the taxpayer obtained the right to acquire additional shares at the time of passing the Board resolution, the receipt of the property happened only at the time of allotment of shares. This was also the date when the property came into existence[2].
- The Tribunal further observed that the transaction was ostensibly covered by the clear and unambiguous language of the provision. However, it also observed that it needed to be understood whether the provision led to unintended or absurd results. It noted that through the medium of additional shares, issued at below market rates, substantial controlling interest in a company or business or property could be passed on. Hence, the provision of bringing to tax the shortfall in consideration over the FMV is on a firm, cogent and sound footing.
- Issue of bonus shares would not be covered under this section, as there was neither any increase nor decrease in the wealth of the shareholders/ issuing company nor any change in the percentage shareholding. It was merely a process of capitalisation of the company's profits. There was no receipt of any

[2] Relied on Supreme Court decisions in the case of Shree Gopal and Company *v.* Calcutta Stock Exchange Limited [1963] 32 Comp. Cas. 862 (SC) and Khoday Distilleries Ltd. *v.* CIT [2008] 307 ITR 312 (SC)

property by the shareholder and what stood received by the shareholder was the split shares out of its own holdings[3].

- However, the Tribunal rejected the taxpayer's argument of comparing the additional shares to shares received by shareholders of a demerged company in the resulting company. It stated that the shareholders were receiving only the value of their existing shares in the demerged company in the form of shares in the resulting company. Furthermore, section 56(2) of the Act specifically excluded shares allotted in a demerger from its ambit.
- The taxpayer's argument that section 56(2)(vii)(c) of the Act was not applicable, as there was neither a transfer in its favour nor was the issuer company the owner of the shares, was rejected by the Tribunal stating that the section nowhere stipulated 'transfer' as a prescribed mode of acquisition. The burden of the Revenue to prove that property was received by the taxpayer was discharged when the Revenue was able to prove that the taxpayer itself was the owner of the property. The Tribunal further observed that where allotment of shares was taken as the event of receipt of property, the taxpayer's argument would fail.
- In the present case, as a result of the transaction, the shareholding of the taxpayer stood reduced from 4.98% to 3.17%. The premise on which it was found that section 56(2)(vii)(c) of the Act was not applicable to bonus shares could be applied in the case of issue of additional shares as well, to the extent it was proportional to the existing shareholding. To the extent the shares subscribed were rights shares, i.e., allotted *pro rata* on the basis of the existing shareholding, the provisions though *per se* applicable, do not operate adversely. A disproportionate allotment under a rights issue may trigger the provisions of section 56(2)(vii)(c) of the Act. Furthermore, no additional property could be said to have been received by the taxpayer to the extent the value of property was derived from existing shareholding, on the basis of which the additional shares are allotted.
- The Tribunal held that as long as there was no disproportionate allotment of shares, there was no scope for any property being received by the taxpayer, as there was only an apportionment of the value of the existing shareholding over a larger number of shares. Hence, no addition under section 56(2)(vii)(c) of the Act would arise in the present case[4].
- The provision was brought in as an anti-abuse measure to tax the understatement of consideration as income in the hands of the recipient. However, it should not be read to alter the meaning of a statutory provision where such meaning was plain and unambiguous.
- Based on the above, the addition of income of INR 27 lakhs was quashed as the amount could not be assessed as income on the grounds of inadequate consideration.

PwC observations

- The conclusion of the Tribunal that "receipt" of shares, irrespective of whether the receipt of shares is by way of transfer or otherwise, is adequate for invoking section 56(2)(vii)(c) of the Act may have wide ramifications for other forms of receipts of shares such as subscription for new shares, etc.
- However, the Tribunal has qualified this analogy for *pro rata* allotment of shares to the existing shareholders and receipt of fresh shares by way of bonus issue, as there is no additional gain derived by the shareholders in such scenarios.
- While a literal interpretation of the provisions may be adopted, as this is an anti-abuse provision, the facts should be analysed having regard to the intention of the section before concluding about its applicability.

[3] Relied on Supreme Court decision in the case of CIT *v.* Dalmia Investment Co. Ltd [1964] 52 ITR 567 (SC) and Khoday Distilleries Ltd. *v.* CIT [2008] 307 ITR 312 (SC)

[4] Dhun Dadabhoy Kapadia *v.* CIT [1967] 63 ITR 651 (SC) and H. Holck Larsen *v.* CIT [1972] 85 ITR 285 (Bom)

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