

Tribunal decides on the applicability of section 56(2)(vii) in the case of rights issue of shares

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In brief

Recently, the Mumbai bench of the Income-tax Appellate Tribunal (Tribunal) held that the provisions of section 56(2)(vii) of the Income-tax Act, 1961 (Act) are not applicable where the taxpayer has subscribed to shares pursuant to offer made under the rights issue, if the same is a *bonafide* business transaction. Further, the provisions of section 17 of the Act are not applicable, as the taxpayer received no benefit in the capacity of an employee.

In detail

Facts

- The taxpayer,¹ a director in a closely held Indian Company had subscribed to additional shares in the Company at a face value pursuant to the rights offer made.
- However, the book value of each share differed.
- The Tax Officer (TO) treated the difference in value of each share as inadequate consideration under section 56(2)(vii)(c) of the Act and taxed the same as additional income in the hands of the taxpayer.
- Alternatively, the TO treated the difference as perquisite liable to tax under section 17 of the Act.

Issue before the Tribunal

Whether the difference

between the book value of shares allotted and the consideration paid by the taxpayer pursuant to the rights issue shall be liable to tax in the hands of the taxpayer, as per the provisions of section 56(2)(vii) or section 17 of the Act?

Revenue's contentions

- The taxpayer received the shares on 28 January, 2010 i.e., after 1 October, 2009, the effective date from which the provisions of section 56(2)(vii)(c) of the Act came into force. Hence, the difference should have been liable to tax.
- Further the tax authorities contended that the taxpayer had subscribed to only a portion of the shares out of total shares offered under the rights issue resulting in disproportionate allotment of shares.

- Alternatively, the Revenue contended that the difference should have been liable to tax as a perquisite under section 17 of the Act, considering that the taxpayer was a director and employee in the Company.

Taxpayer's contention

- The taxpayer cited a Mumbai bench of the Tribunal's ruling dealing with the same facts and circumstances. The said ruling was in the case of another shareholder² of the same Company in which the taxpayer held shares.

Tribunal's ruling

- The Tribunal relied on its previous ruling² having identical facts, and dismissed the Revenue's appeal.
- The Tribunal noted that the

¹ ITA No. 676/Mum/2015

² Sudhir Menon HUF v. ACIT [ITA No. 4887/Mum/2013]

Company issued the shares in compliance with the loan agreement that it had entered into. Thereby, the shares were issued for a *bonafide* business purpose.

- As per the ruling cited by the taxpayer, the provisions of section 56(2)(vii) of the Act are applicable only when shares allotted are higher than proportionate entitlement of the shareholder. In the present case, the taxpayer was offered lesser shares than his entitlement. Accordingly, the Tribunal held that the provisions of section 56(2)(vii)(c) of the Act do not apply.
- The Tribunal further placed reliance on the 2011 circular³ issued by the Central Board of Direct Taxes (CBDT), and Supreme Court⁴ decision to observe that the provisions of

section 56(2)(vii) of the Act do not apply to a *bonafide* business transaction.

- The Tribunal observed that the contract between the Company and shareholders for issue of shares was completed before 1 October, 2009 and the issue of share certificate was a formal routine act that occurred after 1 October, 2009. Accordingly, the provisions of section 56(2)(vii) of the Act do not apply in the present case, as the contract was executed prior to 1 October, 2009.
- The Tribunal further observed that pursuant to the issue of shares, the shareholding of the taxpayer in the Company declined. Accordingly, there was no benefit received by the taxpayer to attract the provisions of section 17 of the Act. Further, relying on a CBDT circular⁵ the Tribunal

held that the shares were not allotted to the taxpayer in his capacity of being an employee of the Company. Therefore, the provisions of section 17 of the Act was not applicable.

The takeaways

- The Tribunal, while deciding the case, has held that the provisions of section 56(2)(vii) of the Act do not apply to a *bonafide* business transaction.
- Further, the issue of shares lesser than the proportionate entitlement of the shareholder do not constitute disproportionate allotment of shares to attract the provisions of section 56(2)(vii)(c) of the Act.

Let's talk

For a deeper discussion of how this issue might affect your business, please contact your local PwC advisor

³ Circular 1 of 2011 dated 6 April, 2011

⁴ ITO v. K P Varghese [1981] 131 ITR 597 (SC)

⁵ Circular 710 dated 24 July, 1995

Our Offices

Ahmedabad

1701, 17th Floor, Shapath V,
Opp. Karnavati Club,
S G Highway,
Ahmedabad – 380051
Gujarat
+91-79 3091 7000

Hyderabad

Plot no. 77/A, 8-2-624/A/1, 4th
Floor, Road No. 10, Banjara Hills,
Hyderabad – 500034
Telangana
+91-40 44246000

Gurgaon

Building No. 10, Tower - C
17th & 18th Floor,
DLF Cyber City,
Gurgaon – 122002
Haryana
+91-124 330 6000

Bengaluru

6th Floor
Millenia Tower 'D'
1 & 2, Murphy Road, Ulsoor,
Bengaluru – 560 008
Karnataka
+91-80 4079 7000

Kolkata

56 & 57, Block DN.
Ground Floor, A- Wing
Sector - V, Salt Lake
Kolkata – 700 091
West Bengal
+91-033 2357 9101/
4400 1111

Pune

7th Floor, Tower A - Wing 1,
Business Bay, Airport Road,
Yerwada, Pune – 411 006
Maharashtra
+91-20 4100 4444

Chennai

8th Floor
Prestige Palladium Bayan
129-140 Greams Road
Chennai – 600 006
Tamil Nadu
+91 44 4228 5000

Mumbai

PwC House
Plot No. 18A,
Guru Nanak Road (Station Road),
Bandra (West), Mumbai – 400 050
Maharashtra
+91-22 6689 1000

For more information

Contact us at
pwctr.knowledgemanagement@in.pwc.com

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