



Mumbai Bench of the ITAT reiterates that the difference between the issue price and FMV in respect of rights shares issued on proportionate basis would not be taxable as income from other sources

Background

The Finance Act (No2), 2009 amended section 56 of the Income-tax Act, 1961 (the Act) to provide that the value of any property received by an individual or a Hindu Undivided Family (HUF) without consideration or for an inadequate consideration will be taxable in the hands of the recipient as income from other sources. Properties were defined to include immovable property being land or building or both, shares and securities, jewellery, archaeological collections, drawings, paintings, sculptures or any work of art. The section was introduced as an anti-avoidance measure to curtail transfer of capital assets without/inadequate consideration. However, the applicability of this provision to issue of shares (particularly right shares) remained unaddressed. The Income Tax Appellate Tribunal ('ITAT') in an earlier case had held that where the new shares are allotted to a shareholder in a proportionate basis, it could not be stated that the shares received by the taxpayer could be said to have been received at an inadequate consideration.

Facts of the case

The taxpayer, who was an employee and a shareholder in Dorf Ketal Chemicals India Pvt. Ltd (the company) a closely held company, increased his shareholding by acquiring 20,94,032 shares @Rs.100/- per share. The number of shares received by the taxpayer were lesser than that offered to him on a proportionate basis.

The company has a wholly owned subsidiary in United States of America. The subsidiary intended to acquire the chemical business of Du Pont Inc., USA. To finance the acquisition, the subsidiary entered into a loan agreement. The loan agreement required the promoters of the company, increase the total net worth of the company to Rs. 150 crores by 31 March 2010. To fulfill the condition for obtaining the loan, the company came up with a rights issue



and offered shares to its shareholders. The taxpayer acquired the above shares as part of this rights issue.

The tax authorities worked out the fair market value of the share at Rs.1438.64 per share and taxed the difference between this value and the amount paid by the taxpayer per share as income from other sources invoking the provisions of section 56(2)(vii)(c) of the Act. The authorities also did not accept the alternative contention of the taxpayer that that value after the date of the issue of fresh shares should be considered as the valuation of the shares, since such value had been drastically reduced with inclusion of the new contribution of capital.

Alternatively, the tax authorities stated that since the taxpayer was an employee, the difference could be treated either as perquisite or profit in lieu of salary.

The taxpayer appealed to the Commissioner of Income-Tax (Appeals), who held that the differential amount could not be taxed as income from other sources or as perquisite or profit in lieu of salary

The tax authorities thereafter appealed to the ITAT.

The decision of the ITAT¹

- The date of the issue of fresh shares could not be considered as the date the valuation of the shares, as the fair market value of the shares in the company has to be determined on the date of issue or prior to the issue date for comparing the reasonableness of the price for invoking provisions of section 56(2)(vii)(c) of the Act.

The factual matrix of the case and that the issue under consideration being squarely covered by the order of the Co-ordinate Bench of Tribunal in the case of taxpayer's brother². Further, considering the detailed reasoning provided by said bench, it was reiterated where there was no disproportionate allotment, i.e., shares were allotted pro rata to the shareholders based on the existing holdings. Hence there was no scope for any property being received by them on the said allotment of shares. There is only an apportionment of the value of the existing holding over a larger number of shares.

The reference to "disproportionate allotment" means disproportionate to the extent the allotment is higher than the proportion offered. However, a higher than proportionate or non-uniform allotment though would and on the same premise attract the rigour of the provision. The tax payer had received less than the proportionate shares allotted to him, which could not be considered as a higher allotment.

The shares were issued by the company to comply with a covenant in the loan agreement. This being a bonafide reason and as a matter of business exigency,

¹ *Subhodh Menon - TS-718-ITAT-2018(Mum)*

² *Sudhir Menon HUF - TS- 146- ITAT-2014 (Mum)*



considering the objective of introducing the provisions as an anti-avoidance measure, the provisions of section 56(2)(vii) would not apply to bonafide business transaction.

Hence the provisions of section 56(2)(vii) cannot be applied to the transaction under consideration.

- Additionally, the company accepted the offer by the shareholders, the contract being completed before the introduction of the provisions, the said section would not be applicable. The issuance of the shares subsequently to the introduction of the provisions was only a routine compliance and could not be considered as the date on which the transaction was completed.
- In respect of the income being chargeable as perquisites or profits in lieu of salary, the shares of the company were not allotted to the taxpayer in his being an employee of the company but in his capacity as a shareholder. Hence the provisions for taxing it as such would not be applicable.

Dhruva Comments

The decision of the ITAT reiterates that the provisions of taxing the difference for receiving property for inadequate consideration would not be applicable in a case where the taxpayer were to be allotted/receive new shares on a proportionate basis to his shareholding in the company. More importantly, the conclusion that the provisions of section 56(2)(vii) could not be applied to bona fide business transactions will have far reaching implications. It is interesting to note that although the legislative history talks about this provision being introduced as a means to counter evasion, the language of provision itself (and of sections 56(2) (viiia) and 56(2)(x) which were subsequently introduced) does not contain any express carve out for 'bonafide business transactions'.



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