

Provisions of Section 56(2)(vii)(c) of the Income-tax Act do not apply to the proportionate issue of right shares

Recently, the Mumbai Bench of the Income-tax Appellate Tribunal (the Tribunal) in the case of Shri. Subhodh Menon¹ (the taxpayer) dealt with the applicability of provisions of Section 56(2)(vii)(c) of the Income-tax Act, 1961 (the Act) vis-à-vis the issue of right shares. The Tribunal held that the provisions of Section 56(2)(vii)(c) of the Act do not apply to the proportionate issue of right shares. Further, such anti-abuse provisions do not apply to bonafide business transactions. The shares are issued to comply with a covenant in a loan agreement with the bank to fund the acquisition of business and the consideration for the shares is received through a banking channel.

With respect to the applicability of Section 17 of the Act relating to perquisite, the Tribunal held that the shares are offered and allotted by the company to the taxpayer in the capacity of a shareholder and not as an employee of the company. Further, shares are offered to the shareholders (who are the employee of the company) and other shareholders at a uniform rate. Therefore, such perquisite provisions are not applicable to the taxpayer.

Background

The taxpayer is a director in a closely held company. As on 1 April 2009, the taxpayer had held 1,04,179 shares in the company, which was equivalent to 34.57 per cent of the total issued share capital of the company. The closely held company had a wholly-owned U.S. subsidiary. During the assessment year (AY) 2010-11, the subsidiary intended to acquire the chemical business of another U.S. company. To finance the acquisition, the subsidiary entered into a loan agreement. The loan agreement required the promoters of the company to increase the total net worth of the company to INR1500 million by 31 March 2010.

In order to comply with the covenant in the loan agreement, the board of directors of the company passed a resolution on 7 September 2009 to issue 6.3 million shares at face value of INR100 to the existing shareholders in proportion to their holding in the company so as to increase the share capital by INR630 million. Based on the existing shareholding of 34.57 per cent, the taxpayer was offered 2.18 million shares at face value of INR 100. However, the taxpayer accepted the part offer of the shares only to the extent of 2.09 million shares. The shares were formally allotted by the company pursuant to the acceptance by the shareholders in September 2009.

The Assessing Officer (AO) held that there was disproportionate allotment of shares to the taxpayer. The AO taxed the difference in face value and fair market value (FMV) of shares under Section 56(2)(vii)(c) of the Act. Alternatively, the AO also held that the shares allotted to the taxpayer being a salaried employee was to be treated as perquisite or profit in lieu of salary under Section 17 of the Act.

The Commissioner of Income-tax (Appeals) [CIT(A)] relied on the decision of Sudhir Menon (HUF)² and held the decision in favour of the taxpayer. The Mumbai Tribunal in the case Sudhir Menon (HUF) ruled out the applicability of anti-abuse provisions under Section 56(2)(vii)(c) of the Act to the taxpayer. The Tribunal observed that as long as there was no disproportionate allotment, (i.e., shares are allotted pro rata to the shareholders based on the existing holdings), there was no scope for any property being received by them on the said allotment of shares. There was only an apportionment of the value of the existing holding over a larger number of shares.

¹ ACIT v. Shri. Subhodh Menon (ITA No. 676/Mum/2015, dated 7 December 2018) – Taxsutra.com

² Sudhir Menon HUF v. ACIT [2014] 148 ITD 260 (Mum)

Tribunal's decision

Applicability of Section 56(2)(vii)(c) of the Act

Relying on the decision in the case of Sudhir Menon (HUF), the Tribunal observed that the provisions of Section 56(2)(vii) of the Act would be attracted only when a higher than a proportionate allotment of shares was received by a shareholder. In the instant case, the taxpayer applied for and was allotted a lesser than the proportionate shares offered to him.

Anti-abuse provisions specified under Section 56(2)(vii) of the Act do not apply to the bona fide business transaction. In the instant case, the transaction of an issue of shares was carried out to comply with a covenant in the loan agreement with the bank to fund the acquisition of the business by the subsidiary in the U.S. The shares were issued by the company for a bona fide reason and as a matter of business exigency. Therefore, such a bona fide business transaction cannot be taxed under Section 56(2)(vii) of the Act.

It has been observed that the consideration for the shares was received through banking channel. The object behind the introduction of Section 56(2)(vii) of the Act should be borne in mind. The Tribunal relied on the decision of the Supreme Court in the case of K P Varghese³ wherein the Court while dealing with old anti-abuse provisions observed that the object and purpose of the provision were not to strike at honest and bona fide business transactions where the consideration for the transfer was correctly disclosed by the taxpayer.

The provisions of Section 56(2)(vii) of the Act are applicable only from 1 October 2009. In the instant case, the offer was made by the company to the shareholders to subscribe for the shares on 7 September 2009 pursuant to a board resolution passed on the same date. Further, on 21 September 2009, the company informed the shareholders about the acceptance of shares offered by the company. Therefore, the offer made by the company was accepted by the shareholders before 1 October 2009, hence, the contract between the company and the shareholder for the issue of shares was completed before 1 October 2009. Accordingly, the provisions of Section 56(2)(vii) of the Act do not apply as the contract was executed prior to 1 October 2009.

Applicability of Section 17 of the Act

The provisions of Section 17 of the Act do not apply to the taxpayer as the shares were not allotted by the company to the taxpayer in his capacity of being an employee of the company. The shares were offered and allotted to the taxpayer by the company by virtue of the taxpayer being a shareholder of the company.

CBDT Circular No. 710, dated 24 July 1995 also supports the taxpayer's stand that where shares were offered by the company to a shareholder, who happens to be an employee of the company, at the same price as have been offered to other shareholders or the general public, there will be no perquisite in the shareholder's hands. In the instant case, the shares were offered to the taxpayer and other shareholders at a uniform rate of INR 100, and therefore, the difference between the FMV and issue price cannot be brought to tax as a perquisite under Section 17 of the Act.

Our comments

The Mumbai Tribunal in the case of Sudhir Menon (HUF) dealt with the issue of applicability of Section 56(2)(vii)(c) of the Act to right issue of shares. The Tribunal had held that where the shares were allotted on a proportionate basis to the shareholders of a company based on their existing holdings and where the additional property was not received by the taxpayer, provisions of Section 56(2)(vii)(c) would not apply.

The Tribunal in the present case relied on the decision in the case of Sudhir Menon (HUF) and held that Section 56(2)(vii)(c) of the Act would be attracted only when a higher than a proportionate allotment of shares have been received by a shareholder. In the instant case, the taxpayer applied for and was allotted a lesser than the proportionate shares offered to him and therefore provisions of Section 56(2)(vii)(c) were not applicable.

The Tribunal's observation with respect to bonafide transactions is also important. The Tribunal observed that a bona fide business transaction could not be taxed under Section 56(2)(vii) of the Act.

³ K P Varghese v. ITO [1981] 131 ITR 597 (SC)

Ahmedabad

Commerce House V, 9th Floor,
902, Near Vodafone House,
Corporate Road,
Pralhad Nagar,
Ahmedabad – 380 051.
Tel: +91 79 4040 2200

Bengaluru

Maruthi Info-Tech Centre
11-12/1, Inner Ring Road
Koramangala,
Bengaluru – 560 071.
Tel: +91 80 3980 6000

Chandigarh

SCO 22-23 (1st Floor),
Sector 8C, Madhya Marg,
Chandigarh – 160 009.
Tel: +91 172 664 4000

Chennai

KRM Towers, Ground Floor,
1, 2 & 3 Floor, Harrington Road,
Chetpet, Chennai – 600 031.
Tel: +91 44 3914 5000

Gurugram

Building No.10, 8th Floor,
DLF Cyber City, Phase II,
Gurugram, Haryana – 122 002.
Tel: +91 124 307 4000

Hyderabad

Salarpuria Knowledge City,
6th Floor, Unit 3, Phase III,
Sy No. 83/1, Plot No 2,
Serilingampally Mandal,
Ranga Reddy District,
Hyderabad – 500 081.
Tel: +91 40 6111 6000

Jaipur

Regus Radiant Centre Pvt Ltd.,
Level 6, Jaipur Centre Mall,
B2 By pass Tonk Road,
Jaipur – 302 018.
Tel: +91 141 - 7103224

Kochi

Syama Business Centre,
3rd Floor, NH By Pass Road,
Vytilla, Kochi – 682 019.
Tel: +91 484 302 5600

Kolkata

Unit No. 604,
6th Floor, Tower – 1,
Godrej Waterside,
Sector – V, Salt Lake,
Kolkata – 700 091.
Tel: +91 33 4403 4000

Mumbai

1st Floor, Lodha Excelus,
Apollo Mills,
N. M. Joshi Marg,
Mahalaxmi,
Mumbai – 400 011.
Tel: +91 22 3989 6000

Noida

Unit No. 501, 5th Floor,
Advant Navis Business Park,
Tower-A, Plot# 7, Sector 142,
Expressway Noida,
Gautam Budh Nagar,
Noida – 201 305.
Tel: +91 0120 386 8000

Pune

9th floor, Business Plaza,
Westin Hotel Campus, 36/3-B,
Koregaon Park Annex,
Mundhwa Road, Ghorpadi,
Pune – 411 001.
Tel: +91 20 6747 7000

Vadodara

Ocean Building, 303, 3rd Floor,
Beside Center Square Mall,
Opp. Vadodara Central Mall,
Dr. Vikram Sarabhai Marg,
Vadodara – 390 023.
Tel: +91 265 619 4200

Vijayawada

Door No. 54-15-18E,
Sai Odyssey,
Gurunanak Nagar Road, NH 5,
Opp. Executive Club, Vijayawada,
Krishna District,
Andhra Pradesh – 520 008.
Tel: +91 0866 669 1000