

TAX FLASH NEWS

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Provisions of Section 56(2)(vii) of the Income-tax Act are not applicable on receipt of bonus shares

Recently, the Karnataka High Court in the case of Dr. Ranjan Pai¹ (the taxpayer) dealt with the issue of applicability of Section 56(2)(vii) of the Income-tax Act, 1961 on receipt of bonus shares by the taxpayer as a shareholder of a private limited company. The High Court held that the issuance of bonus shares does not involve any inflow of funds or increase in the capital structure of the company. It merely involves capitalisation of existing reserves. Further bonus shares do not enrich the shareholder. Profit derived by the taxpayer on account of receipt of bonus shares is adjusted by depreciation in value of equity shares held by him. Therefore, the provisions of Section 56(2)(vii) are not applicable on receipt of bonus shares by the taxpayer. The High Court also observed that the bonus shares were not issued in order to evade any tax.

Facts of the case

The taxpayer is an individual engaged in the medical profession. During the Assessment Year 2010-11, the taxpayer received 10 million bonus shares issued by the Company. The Assessing Officer (AO) invoked provisions of Section 56(2)(vii) and treated receipt of bonus shares as income from other sources since the bonus shares were received from the company without consideration. The Commissioner of Income-tax (Appeals) [CIT(A)] held the decision in favour of the taxpayer. The CIT(A) held that on issuance of bonus shares, there is mere conversion of reserve into capital and, therefore, provisions of Section 56(2)(vii) are not applicable. The Tribunal also held in favor of the taxpayer.

Tribunal's decision

Provisions of Section 56(2)(vii) contemplates two contingencies i.e. firstly where the property is received without consideration and secondly where it is received for consideration less than the fair market value (FMV).

The issue of bonus shares by capitalisation of reserves is merely allocation of the company's funds. There is no inflow of fresh funds or increase in the capital employed, which remains the same. The total funds available with the company remains the same and issue of bonus shares does not result in change in respect of capital structure of the company. Thus, there is no addition or alteration to the profit-making apparatus and the total funds available with the company remain the same.

In substance, when a shareholder gets bonus shares, the value of original shares held by him goes down and the market value as well as intrinsic value of two shares put together will be the same or nearly the same as per the value of original share before the issue of bonus shares. Thus, profit derived by the taxpayer on account of receipt of bonus shares is adjusted by depreciation in value of equity shares held by him.

In the present case, there was no material or record to infer that bonus shares have been transferred with an intention to evade tax. Therefore, CIT(A) and the Tribunal have rightly held that when there is an issue of bonus shares, nothing comes to the shareholders as there was no transfer of the property and therefore provisions of Section 56(2)(vii)(c) are not attracted.

Our comments

The issue with respect to the taxability under the provisions of Section 56(2)(vii) vis-a-vis receipt of bonus shares has been a subject matter of debate before the Courts/Tribunal.

The Supreme Court in the case of Khoday Distilleries Ltd.² in the context of Gift Tax Act, 1958 held that the shares would come into existence only on the allotment. There is a difference between issue of a share to a subscriber and the purchase of a share from an existing shareholder. The first case is that of creation whereas the second case is that of transfer.

¹ PCIT v. Dr. Ranjan Pai (ITA No. 501 of 2016) – Taxsutra.com

² Khoday Distilleries Ltd v. CIT [2009] 176 Taxman 142 (SC)

The Mumbai Tribunal in the case of Sudhir Menon HUF³ held that in the case of bonus shares, there is neither any increase nor decrease in the wealth of the shareholder, and therefore, the provisions of Section 56(2)(vii)(c) would not apply to bonus shares. Subsequently, the Delhi Tribunal in the case of Mamta Bhandari⁴ also held on similar lines.

The High Court in the instant case has held that the issuance of bonus shares does not involve any inflow of funds or increase in the capital structure of the company. It merely involves capitalisation of existing reserves. Further bonus shares do not enrich the shareholder. Profit derived by the taxpayer on account of receipt of bonus shares is adjusted by depreciation in value of equity shares held by him. Therefore, the provisions of Section 56(2)(vii) are not applicable on receipt of bonus shares by the taxpayer. The High Court also observed that the bonus shares were not issued in order to evade any tax.



³ Sudhir Menon HUF v. ACIT [2014] 148 ITD 260 (Mum)

⁴ DCIT v. Smt Mamta Bhandari [2019] 108 taxman.com 207 (Del)

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