

Tax Flash News

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Angel tax provisions under Section 56(2)(vii)(c) are not applicable to the issue of right shares that were allocated in proportionate to the existing shareholding and to the renunciation of right shares by relatives

Executive summary

The applicability of angel tax provisions under Section 56(2)(vii)(c) of the Income-tax Act, 1961 to the issue of right shares has been a matter of debate from a long time. The issue is whether allotment of shares results into transfer of shares and whether there is a pre-existing asset before the allotment of right shares.

Recently, the Gujarat High Court in the case of Jigar Jashwantilal Shah¹ (the taxpayer) has held that the issue of right shares by a company is the creation of property and merely receiving such shares cannot be considered as a 'transfer' under Section 56(2)(vii)(c). Therefore, provisions of Section 56(2)(viii)(c) would not apply to issuance of right shares that were allocated to the taxpayer in proportionate to his existing shareholding in the company.

Further, the renunciation of right shares by wife and father of the taxpayer by not exercising the right to subscribe would not attract the provisions of Section 56(2)(vii)(c). It was held that since the wife and father of the taxpayer directly transferred their shares in favour of the taxpayer, provisions of Section 56(2)(vii)(c) cannot be invoked because both of them are falling in the definition of 'relatives' which are excluded from the purview of Section 56(2)(vii)(c).

However, with respect to shares allotted to the taxpayer as a result of third party shareholder declining to apply for right shares, it was held that it leads to disproportionate allocation of shares in favour of the taxpayer. Accordingly, such transaction was covered under Section 56(2)(viii)(c).

Facts of the case

- The taxpayer, an individual, filed its tax return for Assessment Year (AY) 2013-14 declaring the income which was processed under Section 143(1).
- Subsequently, during the assessment proceedings of Kintech Synergy Limited (KSL), the Assessing Officer (AO) observed that the taxpayer was receiving a salary in the capacity of director of the company and the company had issued 2 lakh right shares.
- 1,03,000 shares were allocated to the taxpayer in proportionate to his existing shareholding in the company, 82,200 shares arose from rights renounced by his father and wife, and 14,800 shares were allotted to the taxpayer as a result of rights renounced by a third party. All these shares were allotted at a face value of INR 10 per share.
- The AO issued a reassessment notice to the taxpayer under Section 148 on the ground that the correct Fair Market Value (FMV) of 2 lakh shares allotted to the taxpayer was INR 255 per share. Thus, the consideration should have been INR 5.1 crores as against the actual consideration paid of INR 20 lakh. Accordingly, the differential amount of INR 4.9 crores was taxed as income from other sources under Section 56(2)(vii)(c).

¹ PCIT v. Jigar Jashwantilal Shah (Tax Appeal No. 96 of 2023) (Guj) – Taxsutra.com

High Court decision

- Section 56(2)(vii)(c) cannot be invoked in respect of the allocation of 1,03,000 right shares allotted to the taxpayer proportionate to his shareholding in the company. It cannot be said that the taxpayer has received any shares as there was no transfer of the shares which pre-existed prior to the issuance of shares by the company.
- There was a vital difference between 'creation' and 'transfer of shares'. The words 'allotment of shares' indicate the creation of shares by appropriation out of the unappropriated share capital to a particular person who has the right to choose for such allotment. Therefore, there is a difference between the issue of a share to a subscriber and the purchase of a share from an existing shareholder. In the first case, it is creation, whereas in the second case, it is 'transfer'.
- As per the provisions of Section 56(2) and the Explanatory Notes to the Finance Bill, 2010, Section 56(2)(vii)(c) ought to be applied only in the case of transfer of shares. It is a trite law that allotment of new shares cannot be regarded as a transfer of shares.
- In order to apply the provisions of Section 56(2)(vii)(c), there must be an existence of property before receiving it. Issue of new shares by a company as a right share is the creation of property and merely receiving such shares cannot be considered as a transfer under Section 56(2)(vii)(c) and thus, such provision would not be applicable on the issuance of shares by the company in the hands of the allottee.
- The Supreme Court in the case of Khoday Distilleries Ltd.² after referring to the decision in the case of Shri Gopal Jalan & Co. observed that the word 'allotment' means appropriation out of previously unappropriated capital of a company, of a certain number of shares to a person, and till such allotment, the shares do not exist as such. Therefore, it is only on allotment that the shares come into existence.
- The intention behind amending Section 56 is never meant to aim for the 'fresh issue' or 'fresh allotment' of shares by a company. Therefore, provisions of Section 56(2)(viii)(c) would not apply to issuance of 1,03,000 shares that were allocated to the taxpayer in proportionate to his existing shareholding in the company.
- About the issue of 82,200 shares, the wife and father of the taxpayer would also not be hit by the provision of Section 56(2)(viii)(c) as both of them would be covered by the exemption with respect to relative³.
- About the issue of 14,800 shares allotted to the taxpayer as a result of third party shareholder declining to apply for right shares, the High Court agreed with the Tribunal's decision who had held against the taxpayer because renunciation of rights in favour of the taxpayer by third party who are not related does lead to disproportionate allocation of shares in favour of the taxpayer. Accordingly, such transaction was covered under Section 56(2)(viii)(c).
- With respect to the valuation of shares, the High Court held that there were concurrent findings of fact which do not require any interference as the CIT(A) had rightly computed the FMV based on the balance sheet which was available on record for the previous year and which was approved in an Annual General Meeting.

Our comments

This is an important decision of the Gujarat High Court which deals with an important principle with respect to applicability of angel tax provisions to right shares. The High Court carved out difference between the 'issue of shares' and 'transfer of shares'. The High Court held that on the issue of right shares, there is no pre-existing asset, which is being transferred to apply the provision of Section 56(2)(vii)(c). It is pertinent to note that language of Section 56(2)(vii)(c) and 56(2)(x)(c) are quite similar and therefore this decision can be helpful while interpreting Section 56(2)(x)(c) vis-à-vis issue of right shares.

³ The Tribunal had held that had the wife and father of the taxpayer directly transferred their shares in favour of the taxpayer, provisions of Section 56(2)(vii)(c) could not have been invoked since both of them are falling in the definition of 'relatives' which are excluded from within the purview of Section 56(2)(vii)(c). As a consequence, it was held that the renunciation of right shares by wife and father by not exercising the right to subscribe would not attract the provisions of Section 56(2)(vii)(c).

² Khoday Distilleries Ltd. v. CIT [2008] 307 ITR 312 (SC), Shri Gopal Jalan & Co. v. Calcutta Stock Exchange Association Ltd. 1964 (3) SCC 698

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