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Tax Flash News

14 April 2025

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Acquisition of shares at below FMV not taxable as Other Income when held as stock-in-trade

Executive summary

The recent decision in the case of *Utility Supply*[1] considers the applicability of section 56(2)(viia) of the Income-tax Act, 1961 (the Act), to shares acquired below fair market value (FMV) when such shares are held as stock-in-trade, rather than capital assets.

The tax officer invoked section 56(2)(viia) and added the difference between FMV and purchase price to the taxpayer's income under the head 'Income from Other Sources.'

The taxpayer contended that section 56(2)(viia) was introduced as an anti-abuse provision. The legislative history links section 56(2)(viia) to section 56(2)(vii)—which clearly applies only to capital assets. Accordingly, section 56(2)(viia) should not apply to genuine business transactions involving trading stock.

The Mumbai Bench of the Tribunal accepted the taxpayer's interpretation, relying on legislative intent, CBDT circulars, and judicial precedents.

[1] *Utility Supply Private Ltd v. DCIT* (ITA No. 3585/M/2024). Source: Taxsutra

Facts of the case[2]

The taxpayer was engaged in the business of investment and trading in shares and securities. It acquired shares of certain private companies and classified them as stock-in-trade in its balance sheet, rather than as investments or capital assets.

The tax officer observed that the FMV of the acquired shares exceeded the purchase price and invoked section 56(2)(viia) of the Act to make additions equivalent to the differential value.

The taxpayer contended that as the shares were acquired strictly for trading purposes and section 56(2)(viia) applies only to receipt of shares as capital assets below FMV, its case fell outside the scope of this provision.

Legal provisions

Section 56(2)(viia) provides that where a firm or closely-held company[3] receives any property, being shares of a closely-held company, for a consideration less than FMV, the differential is taxable as 'income from other sources' in the hands of the recipient.

Similarly, section 56(2)(vii) imposes tax implications on individuals and HUFs[4] receiving property below FMV. In this regard, 'property' is defined to mean specified capital assets including shares and securities.

Notably, section 56(2)(vii), introduced via the Finance (No. 2) Act, 2009, initially applied to a broader class of assets, but the Finance Act, 2010 amended it with retrospective effect to restrict its applicability to capital assets. In the Finance Act, 2010, section 56(2)(viia) was also introduced to extend the anti-abuse framework to firms and companies with respect to shares.

Taxpayer's contentions

Section 56(2)(viia) should be restricted to capital assets and should not apply to stock-in-trade, which is expressly excluded from the definition of a capital asset.

For the purposes of section 56(2)(viia), the shares first have to qualify as property which, as per section 56(2)(vii), includes only capital asset.

[2] Search and seizure was conducted and a notice was issued under section 153A of the Act to the taxpayer. The Tribunal held the approval under section 153D to be invalid and the assessment order to be invalid. This issue has not been covered in this Flash News.

[3] Which is not a company in which the public are substantially interested as defined in section 2(18) of the Act

[4] Hindu Undivided Family

Relying on the Memorandum explaining the provisions of the Finance Bill, 2010, the taxpayer asserted that section 56(2)(viia) was intended as an extension of section 56(2)(vii) from individual/HUF to firms and companies. Therefore, the definition of 'property' under section 56(2)(vii), being restricted to capital assets, should apply to section 56(2)(viia).

Both sections follow similar structures and objectives, and it is a cardinal principle of statutory interpretation to adopt meanings from analogous provisions where terms remain undefined. This approach was supported by judicial precedents such as *Solitaire Diamond Exports*[5] and *Khoday India*[6], which emphasised adopting interpretations from related provisions when standalone definitions are absent.

To establish the *bona fide* nature of its transactions, the taxpayer referred to its Memorandum of Association (MOA), which authorised the trading of shares, and its financial statements, which clearly distinguished between shares held as investments and those held as stock-in-trade.

The taxpayer cited CBDT Circulars[7] and explanatory memoranda to the Finance Bills of 2009 and 2010, asserting that these were anti-avoidance provision, introduced to curb the laundering of unaccounted income and should not apply to genuine commercial transactions.

The taxpayer clarified that no allegation of money laundering had been raised by the Revenue in this case, and that the discounted acquisition price reflected post-COVID underperformance of the target companies.

Revenue's contentions

Section 56(2)(viia) was enacted specifically to prevent tax avoidance through undervalued transfers of unlisted shares and applies regardless of whether they are held as stock-in-trade or capital assets.

The Revenue rejected the taxpayer's claim that section 56(2)(viia) is a mere extension of section 56(2)(vii), arguing that the two provisions apply to different classes of taxpayers. While section 56(2)(vii) refers to individuals and HUFs, section 56(2)(viia) pertains to firms and closely-held companies.

The definition of 'property' should not be imported from section 56(2)(vii) because section 56(2)(viia) does not expressly borrow this definition, other than the FMV computation mechanism.

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[5] *ACIT* v. *Khoday India Ltd*. [2009] 33 SOT 178 (Bangalore)

[6] *Solitaire Diamond Exports* v. *ITO* [2020] 114 taxmann.com 176 (Mumbai – Trib)

[7] CBDT Circulars no. 1/2011 and 5/2010

The language of section 56(2)(viia), which refers to 'property being shares,' is self-contained and indicative of an independent scope.

Although the Finance Act, 2010 amended section 56(2)(vii) to exclude stock-in-trade, it did not extend such exclusion to section 56(2)(viia), which implies legislative intent to include stock-in-trade within its scope.

Section 56(2)(viia) includes specific exemptions for business reorganisations, and in the absence of any such carve-out for stock-in-trade, courts should not read into the statute what has been consciously omitted by the legislature.

The Revenue also sought to challenge the characterisation of the shares as stock-in-trade, citing the following factors:

- Most shares, barring those of one company, had been held for over five years, and the taxpayer's turnover was negligible, implying a lack of active trading.
- The pattern of acquisition suggested an intent to acquire control or a strategic stake, inconsistent with trading activity.
- Book entries are not conclusive for determining the true nature of a transaction for tax purposes.

Tribunal's decision

The subject matter of section 56(2)(viia) is 'any property being shares of a company..' Thus, the asset received should be 'any property' and then 'shares of a company'.

In the absence of a specific definition of 'property' within this section, the interpretation could be guided by section 56(2)(vii), which is restricted to capital assets.

Section 56(2)(viia) was introduced as an extension of section 56(2)(vii) to bring firms and companies within the ambit of anti-abuse provisions applicable earlier only to individuals and HUFs. Accordingly, since stock-in-trade is not covered by section 56(2)(vii), it also falls outside the purview of property as contemplated in section 56(2)(viia).

The Tribunal placed reliance on previous decisions such as *Rajiv Ratanlal Tulshyam*[8] and *Satendra Koushik*[9] and CBDT circular which reiterated that provisions like section 56(2)(vii)/(viia) are not intended to cover genuine business transactions.

It further acknowledged the taxpayer's MOA permitting trading in shares and the financial statements clearly demarcating stock-in-trade from investments. The taxpayer was found to be engaged in the business of trading in shares, and the purchases were consistent with regular business activity.

No evidence had been brought on record by the Revenue to establish any tax evasion, sham transaction, or money laundering. Merely holding the shares over a long period or having low turnover cannot be the foundation for doubting the genuine transaction carried out in regular course of business.

Consequently, section 56(2)(viia) was held inapplicable to shares acquired as stock-in-trade in the ordinary course of business. The additions made by the tax authorities were thus held to be unsustainable.

Our comments

This ruling reinforces an important interpretative principle in taxation—that while substance should not be overridden by mere form, it must always be considered in the context of legislative intent.

It may be noted that both sections 56(2)(vii) and 56(2)(viia) were applicable till 31 March 2017 and have now been replaced by section 56(2)(x).

[8] *ITO* v. *Shri Rajiv Ratanlal Tulshyam* [I.T.A. No.5748/Mum/2017]

[9] *Satendra Koushik* v. *ITO* [2019] 177 ITD 286 (Jaipur - Trib.)

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