



Tax alert: Issue of right shares not taxable on proportionate allotment, on renunciation by relatives

19 January 2024

The Gujarat High Court has held that the provisions of section 56(2)(vii)(c) of the Income-tax Act, 1961 (ITA) are not applicable on allotment of right shares to the taxpayer in proportion of his shareholding in the company and on renunciation of right shares by the relatives in favour of the taxpayer.

In a nutshell



The words "allotment of shares" are used to indicate the creation of shares by appropriation out of the unappropriated share capital to a particular person who has right to choose for such allotment. Therefore, there is a difference between issue of a share to a subscriber and the purchase of a share from an existing shareholder because, the first case is that of creation, whereas the second is that of "transfer" entitled to the right in action.



Allotment of new shares cannot be regarded as 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.



Scroll down to read the detailed alert

Background:

- The taxpayer¹, an individual, filed his return of income for the Financial Year (FY) 2012-13, corresponding to Assessment Year (AY) 2013-14.
- During the course of audit proceedings of an Indian company (say A Co), it was noticed that the taxpayer was receiving salary in the capacity of director of A Co and was also issued certain right shares (say 2,000 shares) at face value of INR 10 in A Co.
- The Assessing Officer (AO) of the taxpayer, therefore, issued notice under section 148 of the Income-tax Act, 1961 (ITA) [relating to issue of notice where income has escaped assessment] to the taxpayer on the grounds that the correct fair market value (FMV) of shares (say INR Y) allotted to the taxpayer exceeded the consideration paid (say INR X) for receipt of shares and as per the provisions of section 56(2) of the ITA [relating to income from other sources], the same should have been taxed in the hands of the taxpayer. Accordingly, the AO computed the FMV of the shares at INR Y per share and held that the differential amount (say INR Z) had escaped assessment in the hands of the taxpayer.
- Aggrieved, the taxpayer filed an appeal and in the course of appellate proceedings, the matter reached before the Ahmedabad Bench of the Income-tax Appellate Tribunal (ITAT). The ITAT noted that, amongst others, the following issues were under consideration:
 - Whether section 56(2)(vii)(c) of the ITA could be invoked in respect of:
 - Allocation of rights shares (say 1000 shares) allotted to the taxpayer proportionate to his shareholding in A Co?
 - Additional shares (say 800 shares) received by the taxpayer since the taxpayer's wife and father did not exercise the rights issue and renounced the same in favour of the taxpayer?
 - Shares allotted (say 200 shares) to the taxpayer as a result of third-party shareholders renouncing their right to apply for rights shares in favour of the taxpayer?

The ITAT in relation to the above, held as follows:

- On conjoint reading of the provision of section 56(2)(vii)(c) of the ITA as well as the explanatory note of the said provision, it was clear that only when an individual or a Hindu Undivided Family (HUF) **receives any property** for consideration which is less than the FMV, the provisions of section 56(2)(vii)(c) of the ITA would be attracted.

In the facts of the case under consideration, the shares had come into existence only when the allotment was made by the company as right shares could not be said to be “received from any person”. The shares which had been allotted to the taxpayer were not “received from any person” which was the fundamental requirement for invoking section 56(2)(vii)(c) of the ITA. In other words, the property had to pre-exist for application of section 56(2)(vii)(c), which was clear from the intention of the legislature. Reliance was placed on earlier rulings² in this regard.
- As long as there was no disproportionate allotment of shares, there was no scope of any property being received on allotment of shares, as there was only an apportionment of the value of their existing shareholding over a large number of shares and hence, no addition under section 56(2)(vii)(c) of the ITA could arise. Therefore, if the shares were allotted strictly on proportionate basis based on existing shareholding, then though the provisions per se were applicable but would not operate

¹ PCIT v. Jigar Jashwantlal Shah [R/Tax Appeal No. 80 of 2023] (Gujarat HC)

² Sudhir Menon HUF vs. ACIT [2014] 45 taxmann.com 176 (Mumbai – Trib.) and Ms. Dhun Dadabhoy Kapadia vs. CIT [1967] 63 ITR 651 (SC)

adversely because the gain accruing on allotment of fresh shares would be offset by the loss in value of existing shares. Reliance was placed on earlier rulings³ in this regard.

- In view of the above, the provisions of section 56(2)(vii)(c) were not applicable in respect of allocation of 1,000 right shares allotted to the taxpayer proportionate to his shareholding in the company.
- With regard to the 800 shares received by the taxpayer, since the wife and father of the taxpayer did not exercise the rights issued and renounced the right in favour of the taxpayer, reliance was placed on a settled principle of law that what could not be done directly, could not be done indirectly as well. That is, had the wife and father of the taxpayer directly transferred their shares in favour of the taxpayer, provisions of section 56(2)(vii)(c) of the ITA could not have been invoked since both of them fell in the definition of 'relatives' which were excluded from within the purview of operation of section 56(2)(vii)(c) of the ITA.

As a consequence, the renunciation of right shares by wife and father of the taxpayer by not exercising the right to subscribe did not attract the provisions of section 56(2)(vii)(c) of the ITA. Reliance was placed on earlier rulings⁴ in this regard.

- With regard to the application of section 56(2)(vii)(c) of the ITA for the balance 200 shares allotted to the taxpayer as a result of third party shareholder declining to apply for right shares in favour of the taxpayer, it was held against the taxpayer because renunciation of rights in favour of the taxpayer by third party who were not related lead to disproportionate allocation of shares in favour of the taxpayer.`

— Whether the first appellate authority erred in accepting the valuation of shares proposed by the taxpayer?

The ITAT in this regard held as follows:

Reliance was placed on earlier rulings⁵ wherein it was held that in case the balance sheet was not drawn on the date of allotment, the previous balance sheet which was approved in the Annual General Meeting (AGM) had to be considered for valuation of FMV of the shares. Therefore, since in the case under consideration the shares were allotted before balance sheet for AY 2013-14, the FMV per share considering the previous balance sheet approved in AGM for valuation of FMV of the shares was to be computed.

- Aggrieved by the ITAT's order, the Revenue filed an appeal before the Gujarat High Court (HC) in relation to the following issues:
 - Deletion of addition under section 56(2)(vii)(c) of the ITA in respect of the additional 800 shares allotted to the taxpayer due to renouncement of rights by wife and father of the taxpayer.
 - Deletion of the addition under section 56(2)(vii)(c) of the ITA in respect of the additional shares allotted to the taxpayer.
 - Valuation of shares in respect of the additional shares allotted to the taxpayer.

Relevant provisions in brief:

Relevant extract of section 56(2)(vii)(c) of the ITA

³ H. Holck Larsen vs. CIT [1972] 85 ITR 285 (BOM.), Deputy Commissioner of Income Tax vs. Smt. Veena Goyal [2020] 119 taxmann.com 362 (Jaipur – Trib.) and Income-tax Officer vs. Rajeev Ratanlal Tulshyan [2022] 136 taxmann.com 42 (Mumbai – Trib.)

⁴ Kumar Pappu Singh v. Deputy Commissioner of Income-tax [2019] 101 taxmann.com 122 (Visakhapatnam - Trib.) and Assistant Commissioner of Income-tax vs. Y. Venkanna Choudary [2019] 112 taxmann.com 71 (Visakhapatnam – Trib.)

⁵ ACIT vs. Y.Venkanna Choudary [2019] 112 taxmann.com 71 (Vishakhapatnam -Trib) and Sadhvi Securities (P) Ltd vs. ACIT [2019] 109 taxmann.com 245 (Delhi – Trib.)

“(2) In particular, and without prejudice to the generality of the provisions of sub-section (1), the following incomes, shall be chargeable to income-tax under the head “Income from other sources”, namely...

... (vii) where an individual or a Hindu undivided family receives, in any previous year, from any person or persons on or after the 1st day of October 2009 but before the 1st day of April 2017...

... (c) any property, other than immovable property,—

(i) without consideration, the aggregate fair market value of which exceeds fifty thousand rupees, the whole of the aggregate fair market value of such property;

(ii) for a consideration which is less than the aggregate fair market value of the property by an amount exceeding fifty thousand rupees, the aggregate fair market value of such property as exceeds such consideration”

Decision of the HC:

The HC noted/observed as follows:

- Section 56(2)(vii)(c) of the ITA could not be invoked in respect of allocation of 1,000 right shares allotted to the taxpayer proportionate to his shareholding in A Co as it could not be said that the taxpayer had received as there was transfer of the shares which pre-existed prior to the issuance of shares by A Co as 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 right to choose for such allotment. Therefore, there was a difference between issue of a share to a subscriber and the purchase of a share from an existing shareholder because, the first case was that of creation, whereas the second was that of “transfer” entitled to the right in action.

The explanatory note to Finance Bill, 2010 clarified that section 56(2)(vii)(c) of the ITA ought to be applied only in the case of transfer of shares. Allotment of new shares could not be regarded as transfer of shares. Therefore, in order to apply the provisions of section 56(2)(vii)(c) of the ITA, there must be an existence of property before receiving it.

Further, the term ‘receive’ has been defined⁶ as “To receive means to get by a transfer, as to receive a gift, to receive a letter or to receive money and involves an actual receipt”. Therefore, issue of new shares by company as right shares was creation of property and merely receiving such shares could not be considered as a transfer under section 56(2)(vii)(c) of the ITA and accordingly, such provision was not applicable on the issuance of shares by the company in the hands of the allottee. Reliance was placed on earlier ruling⁷.

- With regard to issue of 800 shares, the name of wife and father of the taxpayer could also not be hit by provision of section 56(2)(vii)(c) of the ITA as both of them were covered by definition of relative covered in the exemption of relative, and therefore, the provision of section 56 of the ITA was not applicable.
- The findings recorded about valuation of shares did not require any interference as FMV was rightly computed on basis of the balance sheet which was available on record for the previous year and which was approved in AGM.

In view of the above, the HC confirmed the findings of the ITAT.

⁶ As per advanced Law Lexicon Dictionary

⁷ Khoday Distilleries Ltd. vs. CIT [2008] 307 ITR 312 (SC)

Comments:

Whether issuance of rights shares / subscription to rights shares can be considered as receipt of property and accordingly, covered by the provisions of section 56 of the ITA has been a subject of litigation. In this regard, the HC in this ruling has upheld the following principles:

- The words “allotment of shares” are used to indicate the creation of shares by appropriation out of the unappropriated share capital to a particular person who has right to choose for such allotment. Therefore, there is a difference between issue of a share to a subscriber and the purchase of a share from an existing shareholder because, the first case is that of creation, whereas the second is that of “transfer” entitled to the right in action.
- Allotment of new shares cannot be regarded as transfer of shares. In order to apply the provisions of section 56(2)(vii)(c) of the ITA, there must be an existence of property before receiving it.

It may be pertinent to note that the provisions of section 56(2)(vii) of the ITA have been made not applicable w.e.f. 1 April 2017 with the introduction of section 56(2)(x) of the ITA which are applicable from the same date i.e., 1 April 2017 which is on similar lines. Accordingly, one could evaluate if the principles of this ruling could be applied to the provisions of section 56(2)(x) of the ITA in case of issue of rights shares.

We have provided below link to tax alert of an earlier ruling in the context of rights issue:

<https://www2.deloitte.com/content/dam/Deloitte/in/Documents/tax/Global%20Business%20Tax%20Alert/in-tax-gbt-alert-section-562-vii-not-applicable-on-issue-of-rights-shares-to-existing-shareholders-in-proportion-to-their-existing-shareholding-noexp.pdf>

Taxpayers may want to evaluate the impact of this ruling to the specific facts of their cases.

Deloitte.

Deloitte refers to one or more of Deloitte Touche Tohmatsu Limited (“DTTL”), its global network of member firms, and their related entities (collectively, the “Deloitte organization”). DTTL (also referred to as “Deloitte Global”) and each of its member firms and related entities are legally separate and independent entities, which cannot obligate or bind each other in respect of third parties. DTTL and each DTTL member firm and related entity is liable only for its own acts and omissions, and not those of each other. DTTL does not provide services to clients. Please see <http://www.deloitte.com/about> to learn more.

Deloitte Asia Pacific Limited is a company limited by guarantee and a member firm of DTTL. Members of Deloitte Asia Pacific Limited and their related entities, each of which is a separate and independent legal entity, provide services from more than 100 cities across the region, including Auckland, Bangkok, Beijing, Bengaluru, Hanoi, Hong Kong, Jakarta, Kuala Lumpur, Manila, Melbourne, Mumbai, New Delhi, Osaka, Seoul, Shanghai, Singapore, Sydney, Taipei and Tokyo.

This communication contains general information only, and none of DTTL, its global network of member firms or their related entities is, by means of this communication, rendering professional advice or services. Before making any decision or taking any action that may affect your finances or your business, you should consult a qualified professional adviser.

No representations, warranties or undertakings (express or implied) are given as to the accuracy or completeness of the information in this communication, and none of DTTL, its member firms, related entities, employees or agents shall be liable or responsible for any loss or damage whatsoever arising directly or indirectly in connection with any person relying on this communication.