Deloitte.

Tax alert: On issue of shares by WOS, matter remanded to consider favourable ITAT rulings on section 56(2)(viib) applicability

23 September 2024

The Delhi High Court, in relation to applicability of section 56(2)(viib) of the Income-tax Act, 1961 on issuance of shares by a wholly-owned subsidiary (WOS) to its holding company, has remanded the matter back to the Dispute Resolution Panel (DRP) for considering the matter afresh after considering earlier favorable rulings of the Delhi Bench of the Income-tax Appellate Tribunal (ITAT).

In a nutshell

Section 56(2)(viib) of the ITA creates a legal fiction whereby the scope and ambit of expression 'income' has been enlarged to artificially tax a capital receipt earned by way of premium as taxable revenue receipt. Hence, such a deeming fiction ordinarily requires to be read to meet its purpose of taxing unaccounted money and thus needs to be seen in context of peculiar facts of the case under consideration.

The objective behind the provisions of section 56(2)(viib) of the ITA was to prevent unlawful gains by the issuing company, in the garb of capital receipts. The object of deeming an unjustified premium charged on issue of shares as taxable income under section 56(2)(viib) of the ITA, was wholly inapplicable for transactions between holding company and its subsidiary, where no income can be said to accrue to the ultimate beneficiary, i.e., the holding company.

The legal fiction is created for a definite purpose and its application need not be extended beyond the purpose. Bringing the premium received from holding company into the tax net under these deeming fictions, is tantamount to stretching the provision illogically and may not provide clear understanding about taxing own money of shareholders without any corresponding benefit.

Scroll down to read the detailed alert

Background:

- The taxpayer[1] had filed a writ petition before the Delhi High Court (HC) raising, *inter-alia*, the following points:
  - Section 56(2)(viib) of the Income-Tax Act, 1961 (ITA) [relating to taxation of consideration received in excess of fair market value (FMV) of shares issued] inserted vide Finance Act, 2012, is ultra vires, being violative of Article 14 of Constitution of India, 1950;
  - Alternatively, the HC may read down the provision as being applicable in situations where any unaccounted income or money can possibly be involved and **would not apply to issuance of shares by a wholly-owned subsidiary to its holding company**;
  - Quashing the directions issued by the Dispute Resolutions Panel (DRP) to the extent of the addition arising out of section 56(2)(viib) of the ITA.
- The taxpayer's primary claim was that provisions of section 56(2)(viib) of the ITA did not apply in case of issuance of shares by a wholly-owned subsidiary (WOS) to its holding company.

Relevant provisions in brief:

Extracts of section 56(2)(viib) of the ITA:

"Section 56(2):

(1) ……

(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…

…(viib) where a company, not being a company in which the public are substantially interested, receives, in any previous year, from any person, any consideration for issue of shares that exceeds the face value of such shares, the aggregate consideration received for such shares as exceeds the fair market value of the share"

Decision of the HC:

The HC noted / observed as follows:

- The HC acknowledged that the aforesaid issue was covered by an earlier ruling[2] of the Delhi Bench of the Income-tax Appellate Tribunal (ITAT) wherein, amongst others, it was held as follows:
  - Deeming clause requires to be given a schematic interpretation.
  - The transaction of allotment of shares at a premium in the instant case was between holding company and its subsidiary company and thus when seen holistically, there was no benefit derived by the taxpayer by issue of shares at a certain premium, notwithstanding that the share premium exceeded a fair market value in a given case. Instinctively, it was a transaction between the self, if so to say.
  - The true purport of section 56(2)(viib) of the ITA was analyzed in an earlier ruling[3]. It was observed that the objective behind the provisions of section 56(2)(viib) of the ITA was to prevent unlawful gains by issuing company in the garb of capital receipts.
  - The object of deeming an unjustified premium charged on issue of share as taxable income under section 56(2)(viib) of the ITA was wholly inapplicable for transactions between holding and its subsidiary company where no income could be said to accrue to the ultimate beneficiary, i.e., holding company.

[1] FIS Payment Solutions and Services India Pvt Ltd vs Union of India [2024] W.P.(C) 10289/2024 & CM APPL. 42097/2024 (Delhi HC)

[2] BLP Vayu (Project-1) (P.) Ltd. vs. Principal Commissioner of Income-tax [2023] 151 taxmann.com 47 (Delhi - Trib.)

[3] DCIT v. Ozone India Ltd. [2021] ITA No. 2081/Ahd/2018 (Ahd-Trib.)

- The chargeability of deemed income arising from transactions between holding company and its subsidiary or vice versa, militated against the solemn object of section 56(2)(viib) of the ITA.

- The HC also observed that an identical view was expressed by the Delhi ITAT in another earlier ruling[4], which held as follows:
  - Section 56(2)(viib) of the ITA creates a legal fiction whereby the scope and ambit of the expression 'income' has been enlarged to artificially tax a capital receipt earned by way of premium as taxable revenue receipt. Hence, such a deeming fiction ordinarily requires to be read to meet its purpose of taxing unaccounted money and thus needs to be seen in the context of peculiar facts of the case under consideration.
  - The legal fiction was created for a definite purpose and its application need not be extended beyond the purpose for which it has been created.
  - Bringing the premium received from the holding company into the tax net under these deeming fictions, is tantamount to stretching the provision illogically and may not provide clear understanding about taxing own money of shareholders without any corresponding benefit.
- The HC stated that the Revenue authorities had accepted that they remain bound to act in terms of the declaration of the law as embodied in the aforesaid rulings of the Delhi ITAT and that consequently the DRP may be called upon to revisit the direction impugned herein.

In view of the above, the HC allowed the taxpayer's writ petition in part and quashed the DRP's direction. The matter was accordingly remitted to the DRP for considering the issue afresh, bearing in mind the aforesaid rulings of the Delhi Bench of the ITAT.

Comments:

Wholly owned subsidiaries do issue shares at premium to their holding companies. A question arises whether the premium, in excess of FMV, would be subject to tax as 'Income from Other Sources'. The HC in this ruling, while remanding the matter back to DRP, has upheld, *inter alia*, the following principles emanating from the earlier ITAT rulings:

- Section 56(2)(viib) of the ITA creates a legal fiction whereby the scope and ambit of the expression 'income' has been enlarged to artificially tax a capital receipt earned by way of premium as taxable revenue receipt. Hence, such a deeming fiction ordinarily requires to be read to meet its purpose of taxing unaccounted money and thus needs to be seen in context of peculiar facts of the case under consideration.
- The objective behind the provisions of section 56(2)(viib) of the ITA was to prevent unlawful gains by the issuing company, in the garb of capital receipts. The object of deeming an unjustified premium charged on issue of shares as taxable income under section 56(2)(viib) of the ITA, was wholly inapplicable for transactions between holding and its subsidiary company where no income can be said to accrue to the ultimate beneficiary, i.e., holding company.
- The legal fiction is created for a definite purpose and its application need not be extended beyond the purpose for which it has been created.
- Bringing the premium received from holding company into the tax net under these deeming fictions, is tantamount to stretching the provision illogically and may not provide clear understanding about taxing own money of shareholders without any corresponding benefit.

Please refer to our tax alert on the earlier Delhi ITAT ruling as referred to by the Delhi HC in the ruling, below:

https://www2.deloitte.com/in/en/pages/tax/articles/excess-share-premium-not-taxable-on-shares-issued-to-100-holding.html

[4] Deputy Commissioner of Income-tax vs. Kissandhan Agri Financial Services (P.) Ltd [ITA No. 8734/Del/2019] (Delhi-Trib.)

It is pertinent to note that, vide the Finance (No.2) Act, 2024, the provisions of section 56(2)(viib) of the ITA shall not be applicable from 1 April 2025 i.e. FY 2024-25 onwards.

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

Deloitte.