

CBDT's Sec 56(2)(viiia) flip-flop - A black comedy!

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Ashish Sodhani (Leader, International Tax Advisory & Litigation, Nishith Desai Associates)

On December 31, 2018, the Indian Central Board of Direct Taxes (“CBDT”) had issued a circular (“Circular 1”) providing interpretation of the term ‘receives’ in section 56(2)(viiia) of the Income Tax Act, 1961 (“ITA”). Subsequently, on January 4, 2019 the CBDT through another circular rescinded Circular 1 (“Circular 2”) on the ground that the term ‘receives’ is sub-judice in higher juridical forums. Following this, on January 21, 2019, the CBDT issued another circular (“Circular 3”) stating that the Circular 1 shall not be taken into account by any income-tax authority in any proceeding under the ITA. Considering the above developments, it becomes important to analyse what has transpired for issuance of these three circulars in such dramatic fashion.

Section 56(2)(viiia) of the ITA

Section 56 of the ITA taxes those incomes which do not fall under any other head of income under the ITA and hence are taxed as income from other sources under Section 56 of the ITA. Section 56(2)(viiia) of the ITA specifically is an anti-abuse provision which provides for taxation of a company in which the public are not substantially interested (“Specified Company”) or a firm where such Specified Company or firm ‘receives’ shares of a Specified Company for no or consideration which is below the fair market value (“FMV”) of the shares. The tax is levied on receiver of shares on the difference between the FMV of the shares determined as per applicable rules and the consideration actually paid. Note should be made of the fact that Section 56(2)(viiia) of the ITA has been replaced with a new provision (Section 56(2)(x)) which was inserted vide the Finance Act, 2017. Section 56(2)(x) is an all-encompassing provision which provides for taxation of all persons in respect of acquisition / receipt of almost all types of assets (and not just shares), with an exception only in limited cases.

The Controversy

The controversy which resulted in these circulars being issued by the CBDT was on the interpretation of whether the term ‘receives’ (as used under the said provision) includes shares received by way of ‘fresh issuance’ including by way of issuance of bonus shares, rights shares and preference shares etc. or was limited to only a transfer of shares. Stakeholders had made several representations and asked for clarifications from the CBDT on the interpretation of the term.

Circular 1

In order to bring about the much-needed clarity, CBDT issued Circular 1. It placed reliance on the memorandum explaining the provisions of Finance Bill, 2010, which introduced section 56(2)(viiia) (“**Memorandum**”). As per the Memorandum, the legislative intent of introduction of the provision was “...to prevent the practice of transferring unlisted shares at a price much below their fair market value.....”. In view of the same, CBDT through Circular 1 clarified that since the legislative intent of introducing Section 56(2)(viiia) was to curb transferring of shares at low prices, Section 56(2)(viiia) of the ITA shall not be applicable in case of fresh issuance of shares and shall be applicable only in case of transfer of shares for no or inadequate consideration.

The issuance of this circular clarified a long-standing issue of whether ‘receives’ included ‘fresh issuance’. This is because Section 56(2)(viiib) of the ITA was a specific provision covering taxation of ‘fresh issuance’ and hence having Section 56(2)(viiia) for ‘fresh issuances’ would always result in ambiguity and confusion.

Circular 2

CBDT vide Circular 2 rescinded Circular 1. CBDT gave the following reasons for the withdrawal of Circular 1: (i) the matter relating to the interpretation of the term ‘receives’ in Section 56(2)(viiia) of the ITA is pending (sub-judice) in higher judicial forums, and (ii) stakeholders have sought clarifications on other similar provisions in section 56. Owing to the above, the CBDT clarified that it will consider the matter afresh and a comprehensive circular will be issued in due course.

Circular 3

On January 21, 2019 CBDT issued Circular 3 on the same issue. Referring to Circular 2, CBDT in Circular 3 has stated that the CBDT has done a comprehensive review of the interpretation of the term 'receives' used in Section 56(2)(viiia) and similar provisions contained in Section 56(2) and in view of pendency of the issue in various judicial forums and clarifications sought by stakeholders it has clarified the position. The circular then goes on to state that considering the legislative intent of introducing Section 56(2)(viiia) in the ITA, the view that was taken in Circular 1 which was rescinded by Circular 2 would not be correct as it could be subject to abuse and would be contrary to the legislative intent of introducing Section 56(2)(viiia) in the ITA.

It further goes on to say that any view expressed by the CBDT in Circular 1 should be considered to have never been expressed and accordingly Circular 1 shall not be taken into account by any income tax authority in any proceeding under the ITA.

What this means?

The issuance of Circular 1 was perhaps in the right direction and also brought about much needed clarity. While the revocation of Circular resulted in things standing as they were before issuance of Circular 1, by issuing Circular 3, the position has become perhaps worse off for the taxpayer as it seems that CBDT has taken a contradictory position – Circular 3 provides that the view it had taken in Circular 1, that Section 56(2)(viiia) of the ITA would not apply to fresh issuance of shares would not be a correct approach. Therefore, indirectly the CBDT has said that Section 56(2)(viiia) shall apply to fresh issuance of shares. Further, the reasoning for taking this u-turn given is that the view in Circular 2 could be subject to abuse and would be contrary to the express provisions and legislative intent of introduction of Section 56(2)(viiia) in the ITA.

It is interesting to see how Circular 3 states that the view in Circular 1 would be against legislative intent which intent was discussed in Circular 1 which clearly established that the provision was introduced to tax cases of transfer of shares.

Conclusion

Another point of interest in this Section 56(2)(viiia) saga is of the Delhi High Court case of *Sonia Gandhi v. ACIT* [\[1\]](#) [\[TS-526-HC-2018\(DEL\)\]](#), which is now pending in appeal in the Supreme Court of India. In the case, the government argued for a position directly contrary to Circular 1 and the issuance of Circular 3 seems to be an attempt in aligning its position with the government's arguments in the above case now before the Supreme Court.

Going by the above, can it be said that political compulsions seem to be affecting the tax authorities? Considering the way these circulars have been issued, this question certainly becomes important to answer. Also, by virtue of Circular 3, the ambiguity on whether 'receives' includes 'fresh issuance' continues to prevail and the taxpayer is back to square one. Infact, all efforts of the industry who made representation to the CBDT to clarify issue seem to have gone futile.

At this juncture, it also becomes relevant to point out to the recent Notification issued by the Department of Industrial Policy and Promotion ("DIPP") setting out new criteria for start-ups to seek exemption from the applicability of Section 56(2)(viiib) of the ITA. Here also, the CBDT and DIPP have not been able to provide relief to those start-ups which achieve success and are good candidates for additional rounds of funding and all efforts made by such start-ups in the form of representations to the ministry seem to have gone futile as the relief provided by DIPP / CBDT do not provide much cheer.

This article has been co-authored by Afaan Arshad.

[\[1\]](#) [\[TS-526-HC-2018\(DEL\)\]/W.P.\(C\) 8482/2018, C.M. APPL.32580-32582/2018](#)