Tax Hotline

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NO NOTIONAL INCOME ON PRO RATA ISSUE OF SHARES AT BELOW FAIR MARKET VALUE

- Mumbai Tribunal takes substance approach to taxation of notional income arising from subscription to shares at lower than fair market value;
- No tax is payable in case of pro-rata allotment of shares to existing shareholders while tax is, however, payable in case of allotment of shares which results in change in shareholding percentages;
- Renunciation of rights issue offering by one shareholder could impact other shareholders of the company;
- Disproportionate allotments in case of contractual pre-emptive rights and anti-dilution provisions could adversely impact PE investors.

The Mumbai bench of the Income Tax Appellate Tribunal ("**Tribunal**"), in the case of *Sudhir Menon HUF v. Asst. CIT*[1]*,* in the context of the Section 56(2)(vii)(c) of the Income Tax Act, 1961 ("**ITA**"), has ruled that notional income arising on account of receipt of additional shares by the existing shareholders of the company, at a value which is below its fair market value ("**FMV**"), would not be subject to tax provided the additional shares are allotted *pro rata* to all shareholders.

Section 56(2)(vii)(c) of the ITA seeks to tax any individual or a Hindu Undivided Family ("**HUF**") on the notional income arising on account of receipt of any property for consideration which is less than its FMV. Similar provisions are also contained in Section 56(2)(viia) of the ITA which tax notional income on receipt of shares of a private company by another private company or firm, where consideration for such shares is lower than FMV.

FACTUAL BACKGROUND

Sudhir Menon HUF ("**Assessee**") held 15,000 shares in a company, Dorf Ketal Chemicals Private Limited ("**DKCPL**"), representing 4.98% of its share capital. The Assessee was offered additional 3,13,624 shares of DKCPL at a face value of INR 100 each, on a proportionate basis with other shareholders. The Assessee subscribed to 1,94,000 of the offered shares along with the other shareholders, who subscribed to both shares similarly offered to them and the shares not subscribed to by the Assessee. Consequent to such subscription, the Assessee's holding in DKCPL reduced from 4.98% to 3.17%.

As the FMV of the shares of DKCPL shares determined[2] as on September 3, 2009 was INR 1,538 per share, the Assessing Officer ("**AO**") sought to tax the Assessee on the difference between FMV and subscription price of the shares, as 'Income from other sources' under Section 56(2)(vii)(c) of the ITA. The Commissioner of Income Tax (Appeals) confirmed the said levy of tax by the AO. Aggrieved by such order, the Assessee approached the Tribunal on second appeal.

RULING OF THE TRIBUNAL

The Tribunal, after an extensive analysis of Section 56(2)(vii)[3] and its applicability to the specific set of facts, held that the said issuance of shares by DKCPL to the Assessee will not be impacted by the provisions of Section 56(2)(vii). Accordingly, the Tribunal arrived at such conclusion based on the findings discussed below.

The Tribunal has, at the outset, observed that the said offer of issuance of shares could not be treated as a rights issue as Section 81 of the Companies Act, 1956 does not mandate a private company to undertake a rights issue. The Tribunal noted that the scheme of the Assessee did not provide for a right of renunciation by the existing shareholders and that the company was entitled to appropriate that right and offer it to another person, not being an existing shareholder. Hence, this ruling is applicable to any share issuance by a company, whether as a rights issue or otherwise.

The Tribunal observed that in a case where additional shares are issued by a company to the shareholders proportionate to their existing holding, no additional property is received by the shareholder and there is no income in the hands of the shareholders. Accordingly, no tax is payable under Section 56(2)(vii). It is the Tribunal's opinion that a proportionate issue of shares by a company to its existing shareholders is only an apportionment of the value of their existing shareholding over a larger number of shares and no additional property is transferred to them.

However, the Tribunal noted that increase in value of shareholding on account of a disproportionate allotment would be considered receipt of additional property by the shareholders and would attract Section 56(2)(vii). Accordingly, a case where an allotment of shares to a shareholder is disproportionate to his existing holding on account of another shareholder renouncing his right to participate will also be impacted by Section 56(2)(vii).

The Assessee, in the course of arguments, equated the issuance of shares in question to a bonus issuance to emphasize how applicability of Section 56(2)(vii) to the present issuance would make even bonus issuances taxable under Section 56(2)(vii), which would lead to absurd results. In this regard, the Tribunal concurred with the Assessee and observed that in case of issuance of bonus shares, the company only capitalizes its profits without affecting the wealth of the shareholders as their respective shareholdings in the company remain constant. In effect, a bonus issuance is a split in the shares of the company in the same proportion for all shareholders, and while the value of each share is reduced there is no receipt of additional property by the shareholders. The Tribunal relied upon the Supreme Court rulings in *CIT v. Dalmia Investment Co. Ltd.*[4] and *Khoday Distillers Limited v. CIT*[5] to support its conclusion. However, the Tribunal also added that where a bonus issue is coupled with the release of assets by the company in favour of the shareholders, such issuance may be characterized as 'dividend' and the issuing company may be subject to dividend distribution tax. This is similar to the reasoning adopted by the Tribunal to hold that a proportionate issuance of shares to existing shareholders is not subject to tax under Section 56(2)(vii).

The Tribunal also analyzed the import of the word 'receipt' appearing in Section 56(2)(vii). An argument was raised by the Assessee that Section 56(2)(vii) was attracted only in case of receipt of property on account of a 'transfer' from one person or persons to an individual or HUF. As a subscription of shares did not involve a transfer of shares, Section 56(2)(vii) would not be attracted in such case. The Tribunal negated the argument while observing that the receipt of property by the taxpayer in his own right was the edifice for levy of tax under Section 56(2)(vii), thus, implying that the possession of the asset by a taxpayer was the only pre-condition for levy of tax under Section 56(2)(vii) and the manner of possession was inconsequential.

ANALYSIS

This ruling provides significant amount of clarity on an important issue that has not been examined by the judiciary yet and it serves to narrow the applicability of an otherwise broadly worded anti-abuse rule and provides respite to taxpayers. However, the principles laid down in the ruling are applicable only in a very restricted set of circumstances, thus limiting the breadth of the ruling.

The Tribunal has observed that a proportionate issuance to all existing shareholders of the company results in a split in the value of the shares already held by them and there is no change in their *inter se* shareholding in the company. The application of this principle to the present case is inconsistent as there is, in fact, a decline in the shareholding of the Assessee which indicates a disproportionate allotment of shares to the Assessee.

Interestingly, the Tribunal has observed that tax under Section 56(2)(vii) will apply even where the company's offer for subscription is proportionate and uniform, but the allotment is disproportionate. Therefore, one of the most important issues that need consideration here is the application of Section 56(2)(vii) to a rights issue or any other proportionate issuance where certain shareholders renounce their right to subscribe to shares thereby causing disproportionate allotment of shares to the other shareholders. This ruling will also impact private equity investors who are likely to be entitled to disproportionate allotments on account of anti-dilution rights and contractual pre-emptive rights in private companies.

Another point worth consideration is that while the Tribunal has emphasized that no property can be said to have been received by a shareholder where his shareholding remains constant, the Tribunal has also stated that where additional shares are issued on the basis of the existing shareholding in the company, no additional property can be said to have been received by the shareholder. This seems to create an anomaly as the issuance of shares on the basis of existing shareholding in the company may not always be proportionate and could be contractually determined to be non-uniform, resulting in a change in the shareholding.

The discussion by the Tribunal on the point of possession of the property, as evidencing 'receipt' also merits a mention. Section 56(2)(vii) is only applicable where property is "received" from "a person or persons" for consideration which is below FMV. Interestingly, the Tribunal has observed that Section 56(2)(vii) and Section 56(2)(viia) were introduced as anti-abuse rules in lieu of abolition of gift tax in India, which would imply that the said provisions necessarily envisage an element of 'transfer' of property from one person to another and should not cover a situation where property is created in the hands of the recipient. The Tribunal has also noted in the ruling that in case of an allotment of shares, no property comes into existence till the time shares are allotted to a subscriber. Accordingly, as there is no ‘transfer’ of property (shares) in case of an allotment, the current transaction should not fall within the purview of Section 56(2)(vii), which according to the ruling has been introduced to tax incidents of transfer of property without adequate consideration. However, the Tribunal has rejected the argument of ‘transfer’ being a pre-requisite for ‘receipt’ under Section 56(2)(vii).

Although this ruling is a step in the right direction towards providing clarity as to the taxation of notional income, since the ruling is specific to pro-rata allotment to existing shareholders, further clarity is required so as to prevent indiscriminate application of these provisions and principles by the tax authorities.

– Sriram Govind & Neha Sinha
You can direct your queries or comments to the authors

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[1] ITA No. 4887/Mum/2013

[2] Valuation undertaken pursuant to Rules 11U and 11UA of the Income Tax Rules, 1962

[3] S. 56(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,—

(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…

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[4] *CIT v. Dalmia Investment Co. Ltd.*, [1964] 52 ITR 567 (SC)

[5] *Khoday Distillers Limited v. CIT*, [2008] 307 ITR 312 (SC)
