Tax Hotline

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ALLOTMENT OF SHARES TO EXISTING SHAREHOLDER AT LESS THAN MARKET VALUE NOT TAXABLE UNDER SECTION 56(2)(VII) WHERE ALLOTMENT NOT DISPROPORTIONATELY HIGHER THAN EXISTING SHAREHOLDING PROPORTION, AND PART OF GENUINE BUSINESS TRANSACTION

- Following the ruling in *Sudhir Menon HUF,* allotment of shares to the taxpayer (an existing shareholder of a company) at less than FMV should not be taxable under section 56(2)(vii)(c) where the allotment is not disproportionately higher than proportion of shareholding offered to the taxpayer.
- In India there is no gift tax. However, section 56 of the Income Tax Act, 1961 provides that gifts to unrelated parties could be deemed income under certain circumstances. Section 56(2)(vii)(c) seeks to tax receipt of shares at less than FMV on the difference between the FMV and the actual consideration paid.
- Section 56(2)(vii) was introduced as a counter-evasion mechanism to prevent money laundering and hence should not be applicable to genuine business transactions.
- Disproportionate allotment of shares to taxpayer, resulting in decline in shareholding, should not be taxable as 'perquisite' under section 17 as it does not result in additional benefit accruing to the taxpayer.
- In any case, section 17 is inapplicable as share allotment to taxpayer was by virtue of his role as shareholder of company, and not employee.

Recently, the Mumbai Income Tax Appellate Tribunal ("**Tribunal**") while upholding the ruling of its co-ordinate bench in the case of *Sudhir Menon HUF v. Assistant Commissioner of Income-tax*[1] held that additional allotment of shares to an existing shareholder of a company at less than fair market value ("**FMV**") as part of a genuine business transaction should not be subject to section 56(2)(vii)(c) of the (Indian) Income Tax Act, 1961 ("**ITA**"), where the allotment is not higher than the proportion of existing shareholding. Section 56(2)(vii)(c) provides that if individuals and Hindu Undivided Families ("**HUF**") receive movable property (shares) upon paying inadequate consideration, i.e. at a price lesser than the FMV of such property, then the difference between the FMV and the consideration actually paid should be subject to tax in the hands of the recipient.

BACKGROUND

The taxpayer in the present case, Subodh Menon is an individual resident in India ("**Taxpayer**"). In the beginning of the relevant financial year (FY), i.e. FY 2009-10 ("**Relevant FY**"), the Taxpayer held 34.57% of the issued share capital of Dorf Ketal Chemicals India Private Limited, an Indian closely held company ("**Dorf / Company**"), of which he was also a promoter and director. Dorf has a wholly owned subsidiary in the United States of America (US), namely Dorf Ketal Specialty Catalyst LLC ("**Subsidiary**"). During the Relevant FY, the Subsidiary intended to acquire the chemicals business of another US company, i.e. Du Pont Inc.

To finance the said acquisition, the Subsidiary entered into a loan agreement, which required the promoters of Dorf to increase its net worth to INR 150 crores (i.e. by INR 63 crores) by the end of the Relevant FY. In order to comply with the said covenant in the loan agreement, Dorf offered to issue 63,000 shares at the face value of INR 100 each to its existing shareholders in proportion to their holding in the company, which resulted in the Taxpayer being offered 21,78,204 shares at the face value of INR 100. The Taxpayer accepted part of the offer to the extent of 20,94,032 shares through an intimation to Dorf dated September 21, 2009, which shares were formally allotted on January 28, 2010. Since the Taxpayer partly accepted the shares offered to him, his shareholding came down from 34.57% to 33.30%.

The assessing officer ("**AO**") passed an assessment order against the Taxpayer on March 28, 2013 assessing the total income for the Relevant FY to be increased by the amount of difference in value between the FMV of the freshly allotted shares and the consideration actually paid for them (face value of INR 100) under section 56(2)(vii)(c). Further, without prejudice to the abovementioned conclusion, the AO stated that even if section 56 is held to not be applicable, receipt of shares by the Taxpayer, being a director and employee of Dorf, shall be treated as perquisite or profit in lieu of salary as per section 17 of the ITA.

The Commissioner of Income Tax (Appeals) ("**CIT(A)**"), relying on the ruling in the case of *Sudhir Menon HUF* overturned the order of the AO and held that neither section 56(2)(vii) nor section 17 is applicable in the present case of allotment of additional shares. Some of the key observations of *Sudhir Menon HUF,* which were relied upon by the CIT(A) and even the Tribunal in deciding this case are as follows:

- Section 56(2)(vii) was never intended to cover issuance of shares on a 'rights basis' to existing shareholders, even when the offer is below the fair market value.
- For the purposes of section 56(2)(vii), 'receipt' of property (shares) occurs upon allotment. Shares are considered to be allotted on the date of acceptance of the offer to subscribe to the shares.[2]

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- In the case of bonus shares or allotment of additional shares to existing shareholders in the proportion of their shareholding (being akin to 'rights issue')[3] there is neither increase nor decrease in the wealth of the shareholder or of the issuing company and the percentage holding remains the same. What instead transpires is that a share gets split in the same proportion for all shareholders. The Tribunal further exemplified that it is same as somebody exchanging a one thousand rupee note for two five hundred notes. There is therefore no question of any 'gift' or accretion to property. It is a case of shareholders getting only the value of its existing shares, which stands reduced to the same extent.
- As long as there is no disproportionate allotment, i.e. shares are allotted to the existing shareholders in the proportion of their shareholding (pro-rata), there is no scope of receipt of any property. Instead there is only an apportionment of the value of the existing holding over a large number of shares. Having said that, the Tribunal specifically noted that a higher than proportionate or a non-uniform allotment though would, and on the same premise, attract the rigour of the section 56(2)(vii). In essence, the Tribunal concluded that so long as the allotment is equal to or lower than the proportion of shareholding, section 56(2)(vii) should not apply as either of these scenarios do not increase the wealth of the shareholder and is akin to bonus issue.
- The argument of the Revenue that the reduction of the value of the existing shares should not be taken into account to determine taxability under section 56(2)(vii) cannot be accepted. The Tribunal noted that in as much as the value of the additional shares is derived from that of existing shares, the decline in value of existing shares cannot be excluded or ignored to arrive at the value of the additional shares.[4] Further, the Tribunal noted that the said conclusion has statutory backing under section 55(2)(aa) - the provision dealing with cost of capital assets in case they are allotted on the basis of existing shareholding - which clarifies that the values of the original and additional financial assets are interlinked and accordingly, a gain cannot be computed independent of each other.
- Taxability under section 17 only applies in case of inadequate consideration being paid by the shareholder for acquiring the shares which assumes the form of a 'perquisite'. Since in the instant case of additional allotment, no addition is possible (of total income) on account of inadequate consideration, it is not possible to assess the same as 'perquisite' under section 17 of the ITA.

REVENUE'S ARGUMENTS

- The shares of Dorf were allotted to the Taxpayer at the face value of INR 100 instead of its FMV, which was computed to be INR 1538.64. Accordingly the difference between the FMV and the face value per share, i.e. INR 1438.64 should be taxable in the hands of the Taxpayer by virtue of section 56(2)(vii)(c).
- The shares were received by the Taxpayer on January 28, 2010 i.e. after October 01, 2009, the effective date on which section 56(2)(vii)(c) came into effect.
- Following the ruling in *Sudhir Menon HUF,* section 56(2)(vii) (c) should be applicable to the present case of disproportionate allotment of additional shares to an existing shareholder. This contention was based on the fact that while the Taxpayer was offered 21,78,204, he accepted only 20,94,032 shares, thereby resulting in disproportionate allotment.
- Even if section 56(2)(vii) does not apply, the Taxpayer being an employee of the company should be subject to tax under section 17 (as perquisite) on receipt of shares at inadequate consideration.

TAXPAYER'S ARGUMENTS

- The Taxpayer relied on the CIT(A) order and the Tribunal's order in *Sudhir Menon HUF* (his own brother's case) where the exact same issue was considered in detail and was decided in favour of the taxpayer.

RULING

- The ruling in *Sudhir Menon HUF* squarely applies to the issue at hand and hence should be ruled in favour of the Taxpayer. In *Sudhir Menon HUF,* it was observed that 'disproportionate allotment' (in which case section 56(2)(vii)(c) becomes applicable) means *'higher than proportionate or non-uniform allotment'*. In the present case since the allotment was *lower* than the proportion offered, it is not a case of 'disproportionate allotment' and hence not subject to section 56(2)(vii)(c). The Tribunal specifically noted that similar to the issue in *Sudhir Menon HUF,* the shareholding, owing to lower then proportionate allotment, reduced in percentage. Accordingly, since there was no increase in the wealth of the Taxpayer (akin to bonus issue or pro rata allotment), section 56(2)(vii)(c) should not apply.
- Section 56(2)(vii), which was introduced as a counter evasion mechanism to prevent money laundering of unaccounted income[5] does not apply to bona-fide business transactions. The shares in the present case were allotted to the existing shareholders in order to comply with a covenant in the Subsidiary's loan agreement which required the promoters to increase the total net worth of the Company to INR 150 crores. Accordingly, the allotment was for a bona-fide business reason and hence cannot be subject to section 56(2)(vii)(c).
- Section 56(2)(vii)(c) became applicable from October 1, 2009. In the present case, although the formal allotment took place on January 28, 2010, since the offer for additional issuance was accepted by the Taxpayer on September 21, 2009, the contract between the company and the Taxpayer was completed before October 1, 2009 and hence section 56(2)(vii) does not apply.
- Section 17 does not apply in the present case as (i) after the allotment the shareholding of the Taxpayer witnessed a decline (from 34.57% to 33.30%) and hence no benefit was derived by him; (ii) section 17 applies in an employer – employee arrangement and shares in the present case were not allotted to the Taxpayer in his capacity as an employee; (ii) as per CBDT's Circular No. 710 dated July 24, 1995 when shares are offered by a company to a shareholder who happens to be an employee of the company, at the same price as have been offered to other shareholders or general public, there will be no perquisite in the hands of the said shareholder.

ANALYSIS

This judgment plays a crucial role in further establishing a controversial point in law which was already settled by a co-ordinate bench of the same Tribunal in case of the Taxpayer's brother i.e. Sudhir Menon. It essentially clarified that allotment of shares to existing shareholders at less than FMV, should not be subject to section 56(2)(vii)(c) unless the allotment is disproportionate, resulting in higher allotment than the existing shareholding.

Additionally this judgment is significant because unlike in the case of *Sudhir Menon HUF,* it clarified that since section 56(2)(vii) was brought in as a counter-evasion measure, it cannot apply to bona-fide business transactions. This goes a long way in clarifying the exact purport of section 56(2)(vii) which should be instrumental in precluding tax authorities from applying section 56(2)(vii) in case of bona-fide business transactions.

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Interestingly and unlike most instances, in the present case, the CIT(A) had ruled in favour of the Taxpayer. This should set a good example for other income tax officers adjudicating matters at the appellate level to apply the correct law as opposed to blindly ruling against the Taxpayer. In fact, regard must be had to the CIT(A)'s observation in the present case who stated in his order (in response to the Revenue's statement that it had not accepted the Tribunal's decision in *Sudhir Menon HUF* and had challenged it before the High Court) that while it is the right of the department to contest orders of appellate authorities before higher forums such as High Courts; till such time that the higher forum stays or reverses the order of the appellate authorities, that order remains binding on all the lower authorities.

– Afaan Arshad & Varsha Bhattacharya
You can direct your queries or comments to the authors

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[1] [2014] 148 ITD 260 (Mumbai – Trib)

[2] *Khoday Distilleries Ltd. v. CIT* [2008] 307 ITR 312 (SC)

[3] Section 81 of the Companies Act, 1956 which makes it mandatory to issue shares on a 'rights issue' basis is not applicable to private companies. Hence private companies issuing shares to existing shareholders in the proportion of their shareholding, although akin to a 'rights issue' cannot strictly be considered to be a 'rights issue'.

[4] *Dhun Dadabhoy Kapadia v. CIT* ([1967] 63 ITR (SC); *H Holck Larsen v. CIT* [1972] 85 ITR 285 (Bom).

[5] CBDT Circular No. 1/ 2011 dated April 6, 2011.
