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*Analysing developments impacting business*

### TAX TRIBUNAL HOLDS THAT SECTION 56 WOULD NOT APPLY IN THE ABSENCE OF ANY DISPROPORTIONATE ALLOTMENT OF SHARES TO EXISTING SHAREHOLDERS

20 December 2018

#### Introduction

In a recent case of *The Assistant Commissioner of Income Tax Vs. Shri Subodh Menon* (ITAT order dated 7 December 2018), the Mumbai bench of the Income Tax Appellate Tribunal (Tribunal) has held that a shareholder cannot be taxed under Section 56(2)(vii) of the Income-tax Act, 1961 (IT Act) so long as shares are allotted to him on a proportionate basis, even if such shares are allotted at lower than the fair market value (FMV) under Section 56(2)(vii) (Ruling). In doing so, the Tribunal relied on the view of its coordinate bench on the same facts in an earlier case (*Sudhir Menon HUF [2014] 162 TTJ 425 (Mumbai - Trib.)*) concerning the brother of Shri Subodh Menon (Taxpayer). The Tribunal has also held that such allotment cannot be taxed as salary in the hands of the Taxpayer.

Section 56(2)(vii) of the IT Act provides that if a person (as specified) received certain specified properties (which includes unquoted shares) for nil or inadequate consideration, the difference between FMV (computed as per prescribed method) of such property and the consideration paid, if any, was taxed as income in the hands of the recipient under income from other sources, provided the difference exceeded INR 50,000.

#### Background

The Taxpayer, an Indian resident, was the promoter and director of an Indian Private Limited Company (the Company) during financial year (FY) 2009-10. During the year, the Taxpayer subscribed to only a portion of the total additional shares offered to him at the face value of INR 100 per share. The per share FMV of such subscribed shares, as per section 56(2)(vii) was INR 1538.64.

As he accepted only part of the shares offered to him, the Taxpayer's total equity stake in the Company fell from 34.57% to 33.30%.

Further, while the shares were offered for allotment and subscribed as such in the month of September 2009, the shares were actually issued and allotted on 28 January 2010. The provisions of section 56(2)(vii) were applicable from 1 October 2009 only.

The Income Tax Authority (Assessing Officer) considered the difference between the FMV (INR 1538.64) and the price paid (INR 100), as the Taxpayer's income for each share subscribed by him, under section 56(2)(vii) of the IT Act. As the Taxpayer was a

director of the Company the Assessing Officer taxed the difference as a perquisite (salary) under section 17 of the IT Act.

The Taxpayer filed appeal with the first level appellate authority (CIT(A)), who adjudicated the issue in favour of the Taxpayer. Thereafter, the Assessing Officer filed an appeal before the second level appellate authority (Tribunal).

### **Ruling**

Relying on the coordinate bench's earlier view in the case of the Taxpayer's brother (*Sudhir Menon HUF*), the Tribunal dismissed the tax department's appeal and held that as there was no disproportionate allotment of shares via-a-vis the Taxpayer's existing percentage of shareholding in the Company, receipt of shares at a lower than the section 56(2)(vii) prescribed fair market value cannot be taxed in the Taxpayer's hands under section 56(2)(vii) of the IT Act. The Tribunal clarified that the 'disproportionality' cited in the *Sudhir Menon HUF* case is to be read as disproportionality on the higher side, i.e. acquisition of additional shares which effectively increases the overall percentage shareholding of the shareholder in the Company.

The Tribunal also held that in the current facts (and as in the facts of *Sudhir Menon HUF* case) the Taxpayer's shareholding was in fact reduced after the issue of additional shares (from 34.57% to 33.30%) as he only partially accepted the offer given to him, section 56(2)(vii) of the IT Act should not be invoked.

Relying on the CBDT Circular 1/2011 dated 6 April 2011 (which *inter alia* states that section 56(2)(vii) was inserted as a counter evasion mechanism to prevent money laundering of unaccounted income), the Tribunal held that as the issue of additional shares was bonafide, necessitated by a covenant of the Company's USA Subsidiary's loan agreement, carried out through banking channels and in the absence of any allegation regarding money laundering, no addition under section 56(2)(vii) could be made.

The Tribunal also held that section 56(2)(vii) was inapplicable in the current facts because it applied from 1 October 2009, whereas the contract between the company and the shareholder for issue by the company of shares was completed before such date. It was only the formal routine act of issuance of the share certificate by the company which took place after 1 October, 2009.

As regards salary taxation, the Tribunal held that there is no perquisite because the overall shareholding percentage of the Taxpayer actually reduced from 34.57% to 33.30%. The Tribunal also held that the provisions of salary taxation cannot be invoked as the aforesaid additional shares were received by the Taxpayer in his capacity of an existing shareholder, and not as an employee of the Company. Relying on the CBDT circular No. 710 dated 24 July 1995, the Tribunal also held that where a company offers shares to the employees at the same price as have been offered to the other shareholders or the general public, there will be no perquisite in their hands.

### **Comments**

The principles laid down in this Ruling will also be useful while determining implications under Section 56(2)(x), which is *pari materia* to Section 56(2)(vii). It is also encouraging to see that in this Ruling the Tribunal has given credence to the bonafides and drivers of the transaction from a business perspective, instead of adopting an approach of strict interpretation of the language of the taxing statute.

While the Tribunal has provided some certainty by stating that so long as there is no disproportionate allotment of shares, the anti-abuse provisions of section 56(2)(vii) cannot be invoked, one would need to evaluate on a case to case basis on various

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factors whether the allotment is resulting in any effective increase of individual shareholding, purpose of issue, value at which shares are allotted, etc., in order to mitigate any undesirable income-tax consequences and to avoid litigation risk.

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