

TAXATION OF GIFTS

U/s. 56(2)(viiia)

BY

CA NAVEEN KHARIWAL .G

HISTORY OF GIFTS

Gift tax was introduced in India in the year 1958 and continued for more than 40 years.

It was by the Finance (No.2) Act, 1998 that the Gift Tax Act was Abolished.

The Finance Minister in the course of his budget speech stated that the collection of gift tax was insignificant. It was also conceded that Gift Tax Act had not been successful as an instrument to curb tax evasion and avoidance. As a result Gift Tax was abolished.

At the same time, to ensure that there are no leakages of income tax revenue through the mechanism of gifts, the Income Tax Act was proposed to be amended to tax gifts as income in the hands of the recipient.

Therefore the then Finance Minister had by finance (No.2) Act,1998 made a proposal to tax the properties – movable or immovable - without consideration in money or monies worth as income on or after 01.10.1998 in the hands of the recipient. However, as a result of representations received, the proposal to tax gifts as income was dropped.

The Finance (No.2) Act, 2004 converted to reality the aborted attempt of 1998. In the course of the presentation of the Budget Speech of 2004, the Finance Minister stated that "the objective of amendment is to prevent money laundering. Purported gifts from unrelated persons are therefore to be taxed as income". The amendment as ultimately effected does not specifically refer to gifts but refers to any sum received without consideration from any person. The amendment was by insertion of clause (vi) to section 56(2) and a corresponding reference in section 2(24) defining 'income'.

A new clause (clause vi) was inserted by the Taxation laws (Amendment) Act, 2006 to be operative from April 1, 2007. Gifts received on or after April 1, 2007 were to be taxed under the new provision. Clause (vi) was operative up to October 1, 2009. The Finance (No.2) Act, 2009 made this clause inoperative in respect of gifts received on or after October 1 2009. A new clause (vii) was inserted to tax gifts received by on Individual or Hindu Undivided Family (HUF) on or after October 1, 2009.

CHARGEABILITY SECTION	INCOME AS PER	FOR THE PERIOD	APPLICABLE ASSESSMENT YEARS	LIMIT OF EXEMPTION
56(2) (v)	2(24) (xiii)	01.03.2004 to 30.03.2006	2005-2006 2006-2007	25,000/-
56(2) (vi)	2(24) (xiv)	01.04.2006 to 30.09.2009	2007-2008 2008-2009 2009-2010 2010-2011	50,000/-
56(2) (vii)	2(24) (xv)	01.10.2009 onwards	2010-2011 and onwards	50,000/-
56(2) (via)	2(24) (xv)	01.06.2010 onwards	2011-2012 and onwards	50,000/-

AMENDMENT IN FINANCE ACT 2010 - SECTION 56 (2) (viiia)

The Finance Act 2010 has amended section 56(2) of the Income-tax Act, 1961 (Act). A new clause (viiia) to section 56(2) is added. The amendment is to be effective from June 1, 2010. The new clause (viiia) is as below:

“(viiia) where a firm or company not being a company in which the public are substantially interested, receives in any previous year, from any person or persons, on or after 1st day of June 2010, any property, being shares of a company not being a company in which the public are substantially interested,-

- 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:

Provided that this clause shall not apply to any such property received by way of transaction not regarded as transfer under clause (via) or clause (vic) or clause (vicb) or clause (vid) or clause (vii) of section 47.

Explanation – For the purpose of this clause, “fair market value” of a property, being shares of a company not being a company in which the public are substantially interested, shall have the meaning assigned to it in the Explanation to clause(vii);”

Section 2(24)(xv) is amended to include the income of nature referred in clause (viia) of section 56(2), that is, the receipt of shares.

Section 49(4) is amended to provide that for computing capital gains cost of acquisition of the shares, value whereof is subject to tax under section 56(2)(viia) shall include such value.

ANALYSIS

56 (2)(viii) 3 Parties

- 1) Person/s who hold shares
- 2) Firm/Co, not being a company in which public are substantially interested who receive the shares
- 3) Company not being a company in which public are substantially interested whose shares is the subject matter.

“Without consideration”

was brought in to capture gifts in the hands of recipients

“With Consideration”

was brought in to capture transactions involving transfer at “lesser value”.

- ◆ Consider the following details regarding shares transferred of a company in which public is not substantially interested.
- ◆ Transaction value Rs. 1/-
FMV Rs. 12,00,000/-
Cost of Acquisition Rs. 10,00,000/-

- ◆ Case 1 – with consideration

- ◆ In the hands of seller

◆ Sale consideration	Rs.	1
Less: Cost of Acquisition	Rs.10,00,000	

Loss to be C/f.		9,99,999

◆ Case 1 – with consideration

◆ In the hands of purchaser

Amount taxable is the difference between transaction value and Fair Market value.

FMV	Rs.12,00,000
Transaction Value	Rs. 1

Amount Taxable	11,99,999

◆ Case 2 – without consideration

◆ In the hands of seller

No Loss can be carried forward

In the hands of Purchaser

Entire Rs. 12,00,000/- will be taxed.

Salient features of the provision

The provision, would apply in the following circumstances or could be applied subject to fulfilment of the following conditions:

- (a) It applies to a firm or a closely held company (Entity)
- (b) Entity receives the Shares (a taxable event)
- (c) The receipt should be of property, being the Shares
- (d) The receipt is from any person or persons

- (e) The receipt is on or after 1-6-2010
- (f) The Shares are received, without consideration, the aggregate fair market value (FMV) whereof exceeds Rs. 50,000
- (g) The Shares are received for a consideration less than the aggregate FMV of the Shares in excess of Rs. 50,000
- (h) The receipt is not of the nature referred in relevant clauses of section 47 of the Act

For the purpose, FMV is defined to mean value determined as per prescribed method

- If the aforesaid conditions are satisfied:

in the situation mentioned in (f) above, the whole of aggregate FMV constitutes income of Entity (under the head 'Income from other sources'); and

- in the situation mentioned in (g) above, the whole of such excess constitutes income of Entity (under the head 'Income from other sources').

TO ILLUSTRATE:

Suppose M has sold shares to M/s XYZ (a firm) for Rs.20 lakhs. FMV thereof as per prescribed method is Rs. 22 lakhs. The difference is Rs. 2 lakhs and is in excess of Rs. 50,000. Accordingly, M/s. XYZ would be chargeable to tax on Rs. 2 lakhs under the Clause.

Object of amendment and features explained in Memorandum

The Memorandum explaining the provisions of the Finance Bill, 2010 explains the reason and objective behind introduction of clause (viiia) of section 56(2) in the following terms:

“These are anti-abuse provisions which are currently applicable only if an individual or HUF is the recipient. Therefore, transfer of shares of a company to a firm or a company, instead of an individual or HUF, without consideration or at a price lower than the fair market value does not attract the anti-abuse provision.

In order to prevent the practice of transferring unlisted shares at price much below their fair market value, it is proposed to amend section 56 to also include *within its ambit transaction undertaken* in shares of a company (not being a company in which the public are substantially interested) either for inadequate consideration or without consideration where the recipient is a firm or a company (*not being a company in which the public are substantially interested*).”

The features of the provisions as per the Memorandum are:

- (a) It seeks to cover 'transfer' of the Shares to Entity.
- (b) Such transfer is without consideration or for a lower consideration or inadequate consideration.
- (c) It is to prevent the practice of transferring unlisted shares at prices that are below their fair market value.
- (d) Accordingly, the provision is to include within its ambit, transaction undertaken in the Shares either for inadequate consideration or without consideration.

(e) The transactions sought to be covered are the transactions in the nature of transfer by one person to Entity without consideration (being a gift) or for inadequate consideration (that is, sale or exchange, etc.).

On comparing the features of the Clause outlined in the Memorandum with the features of the Clause, two prominent and noticeable differences are:

- (a) The Memorandum refers the transactions as transfer whereas the Clause refers to the transaction as 'receives' or 'receipt' ..
- (b) The objective or the reason behind the Clause as explained in the Memorandum is not evident from the provision.

Accordingly, in a given case, a question could arise about the interpretation of ambiguity in the language of the provision and, in that case, whether the mischief rule could be applied or not. To put it differently can one consider the reason explained for interpreting the terms or language used in the Clause so as to bring out the intention of the provision?

Mischief Rule/Purposive Construction (as contemplated in *Principles of Statutory interpretation* by Justice GP Singh (seventh edition, page No. 98) reads as follows. "When the material words are capable of bearing two or more constructions the most firmly established rule for construction of such words "of all statutes in general (be they penal or beneficial, restrictive or enlarging of the common law)" is the rule laid down in Heydon's case which has "now attained the status of a classic"

The rule which is also known as 'purposive construction' or 'mischief rule', enables consideration of four matters in construing an Act:

- (i) What was the law before the making of the Act,
- (ii) What was the mischief or defect for which the law did not provide,
- (iii) What is the remedy that the Act has provided, and
- (iv) What is the reason of the remedy.

The rule then directs that the courts must adopt that construction which "shall suppress the mischief and advance the remedy:

VALIDITY OF LAW

a) Entity may negotiate a deal for purchase of shares by hard bargaining so as to reduce the cost, which may be lower than fair market value. The seller may agree to do so under the commercial and economical conditions and circumstances. Yet, saving in cost by Entity (representing the difference between purchase price and fair market value) would constitute income. It is settled law that saving in expenditure cannot constitute income (see para I I, page No. 205 of the Law and Practice of Income-tax, 9th Edition, VoL 1, Kanga, Palkhiwala and Vyas).

(b) Even in a case where the Shares are received pursuant to a transaction value approved by any authority or determined as per the method prescribed by any authority, the consideration may have to be benchmarked with the value determined in accordance with the prescribed method (which may not include the method prescribed by any other authority) and determine lower or inadequate consideration.

Thus, the provision would apply even in a case where the transaction is at a fair value (approved or determined by an authority under other laws) between unrelated parties.

(c) In *KP. Varghese v, ITO* [1981] 131 ITR 597/7 Taxman 13, the Supreme Court interpreted section 52(2) of the Act (as existed then) providing for taxation of understatement of consideration. While interpreting the provision it observed that in a case where full value of consideration is **correctly declared**, literal construction of section 52(2), would result in an amount being taxed which is **neither accrued nor received**, which from no view point can be rationally considered as capital gain or any other type of income.

It further observed (page 617):

' under entry 82 in List I of the Seventh Schedule to the Constitution, which deals with "Taxes on income other than agricultural income" and under which the IT. Act, 1961 has been enacted, Parliament cannot "choose to tax as income an item which in no rational sense can be regarded as a citizen's income or even receipt. Sub-section (2) would, therefore, on the construction of the revenue, go outside the legislative power of Parliament and it would not be possible to justify it even as an incidental or ancillary provision or a provision intended to prevent evasion of tax

(d) Principles of construction - The Clause deems a receipt as income and accordingly charges to tax. A taxing provision has to be strictly construed [CITv. Kasturi & Sons Ltd. [1999] 237 ITR 24/103 Taxman 342 (SC)]. Also, it taxes artificial income and the provisions imposing tax on such artificial income should be strictly construed [see CITv. Bhupender Singh Atwal [1983] 140 ITR 928/13 Taxman 254 (Cal.)].

(e) To determine or compare with fair market value, it is usual legislative practice to provide the criteria and/or provide a margin. To illustrate, section 52(2) of the Act (as existed then) provided for a margin of 15%; Rule 1 D of the Wealth-tax Rules, 1957 provided for a discount of 15%; Transfer pricing provisions provides a margin of 5%, etc.

Recently notified Rule prescribing method for determination of fair market value, in case of unquoted shares, does not provide for any such margin. The value determined as per the method is treated as fair market value.

The above issues may have a bearing on effective application of the provision including its constitutional validity

“TARGET” ASSESSEE

- A) **Firm**
- B) **Company (not being a company in which public are substantially interested)**

Firm is defined U/s. 2 (23) of the Act and it shall have the same meaning as assigned to it in the Indian Partnership Act, 1932. Further, it includes a Limited Liability Partnership (LLP) as defined in the Limited Liability Partnership Act, 2008 (LLP Act).

The definition of a company in which public are substantially interested is provided in section 2(18) of the Act. Any company not satisfying this definition would be covered by the proposed amendment.

Other entities would not be covered.

Thus, an Association of Persons, Body of Individuals, artificial juridical person, Co-operative Society, local authority would be outside the ambit of the proposed law. So would be companies in which the public are substantially interested.

In the case of trusts, the trustees are assessable in the like manner and to the same extent as the beneficiaries. The Supreme Court in CWT Vs Trustees of HEH Nizam's Family (Remainder Wealth) Trust 108 ITR 555 held that one of the effects of the said fiction is to attribute to the trustees, the same status as that of the beneficiaries. If the beneficiary is a closely held company/firm, the trustee is liable to be assessed as a company/firm. Therefore, any shares received by the trustees for the benefit of a closely held company or firm would be covered by the proposed clause (viiia).

“TARGET” ASSET

The target assessee should receive a share of a company in which public are not substantially interested.

Share is defined by Sec. 2 (46) of Companies Act 1956 as follows:

“share is a share in the share capital of the company” and includes stock except where a distinction between stock and shares is expressed or implied”.

The term would include both equity shares as well as preference shares.

Accordingly, when a firm or closely held company receives shares without consideration or for inadequate consideration the same would be liable to tax under the proposed clause (viiia) of section 56(2) of the Act.

FEATURES OF SHARE

The following features of 'share' can be inferred as under:

- (a) It's a capital contribution of proprietary nature.
- (b) A share represents a bundle of rights (right to: appoint Board of Directors, participate in management, dividend, vote, distribution of assets upon winding up or otherwise, obtain further shares, etc.).
- (c) It is also subject to risks as also obligations and covenants contained in Articles with Company and/ or other shareholders.
- (d) Such rights are against the company.

- (e) Upon issue or allotment, a company invites capital contribution and creates shares, in terms of the issue provisions and its Articles.
- (f) Till allotment a share does not come into existence. To put it differently, a share does not constitute a share in the hands of the company in as much as the company does not own and cannot own its share. It becomes a property in the hands of allottee. Prior thereto it does not constitute goods.
- (g) It becomes movable property upon issue and allotment capable of being transferred in terms of section 82 of the Companies Act, 1956. Share of a member is property.
- (h) Unsubscribed capital or potential shares at any stage prior to issue or allotment cannot be regarded as shares as the share comes into existence only when allotted to a shareholder and it represents, inter alia, rights in or with respect to the profits/ assets of the company, which are of the ownership of the company.

Debentures is a formal document constituting acknowledgement of a debt by a company usually given under its common seal and normally containing provisions regarding payment of interest, principal and security. Debentures are treated as debts of a company. Debentures are not shares. Accordingly, the receipt of debenture for inadequate consideration or without consideration would not be covered within the proposed clause (viiia).

A convertible debenture may be regarded as a “quasi” equity. The question for consideration is whether a receipt of convertible debenture would be covered within the proposed clause (viiia)? The Rajasthan High Court in case of Commissioner of Income-tax v Secure Meters Ltd – 321 ITR 611 held that ‘debentures when issued is a loan and therefore whether it is convertible or non-convertible does not militate against the nature of debenture, being loan’. The Supreme Court has dismissed the special leave petition filed by the Department on the above case.

Also, Karnataka High Court in case of ITC Hotels Ltd – 2009 TIOL P 678, relying on the decision of Secure Meters decision of the Rajasthan High Court has held that convertibility of debentures into shares does not alter the nature of debenture as debt and expenditure incurred on the same continues to be revenue in nature. Convertible debenture continues to be debt of the company. The receipt of the same would not be covered under the proposed clause (viiia).

'WHEN CHARGEABLE'

The taxable event is the receipt of the target asset by the target assessee. Given below is the relevant portion of the clause (vii):

“where a firm or closely held company receives in any previous year, from any person or persons, on or after 1st day June 2010, any property, being shares of a company in which public is not substantially interested”.

As per the Advanced Law Lexicon dictionary, the term ‘receive’ has been defined as “To receive means to get by a transfer, as, to receive a gift, to receive a letter, or to receive money and involves an actual receipt”. The taxability for the target assessee is triggered on receipt basis.

Receipt on or after 1-6-2010

The provision is applicable in respect of receipt of the Shares, without or for lower consideration, on or after 1-6-2010. Generally, in case of shares, the transfer could be regarded as complete, subject to the terms of contract, upon delivery of shares along with duly completed and executed transfer forms. Thus, it can be said that on receipt of the transfer forms with physical share certificate, the receipt is completed. Accordingly, if any transfer undertaken prior to 1-6-2010 is completed on or after 1-6-2010, the Clause may apply

“Aggregate” means a collection of individual units or things, in order to form a whole; to collect into a whole; formed by combining into a single whole or total.; an assemblage of particulars; an agglomeration. Aggregation presupposes. A consolidation and examining the results after the consolidation.

Take for example for following illustration of receipt of shares with consideration by a target assessee during the year:

Sl No	Market Value	Transaction Value	Excess (+)or Deficit(-)
I	2,00,000	1,75,000	+25,000
II	4,00,000	3,50,000	+50,000
III	5,00,000	5,50,000	-50,000
Total	11,00,000	10,75,000	+25,000

Section 56(2) (viiia) brings to tax shares received during a year. Each share could be held to constitute a separate source. The mechanism of computation of income is always to be applied source wise. The provisions of section 56(2) (viiia) would thus have to be repeatedly applied to every single share. On such a consideration one could draw an initial conclusion that the basic exemption would attach to individual share. However, the section uses the word 'aggregate'. In such scenario, all the shares received would have to be aggregated.

On such aggregation if the basic limit of Rs 50,000/- is breached, no exemption would be available. Conversely, if on aggregation it is noticed that the limit of Rs 50,000/- is not breached, no tax would be leviable despite the fact that at individual transaction level, the deficiency is in excess of Rs 50,000.

However, the Clause does not contemplate or require aggregation of the receipts referred in different sub-clauses. To illustrate, A Ltd. has received:

- ◆ (a) the Shares of FMV of Rs. 45,000 from Mr. X, without consideration; and
- ◆ (b) the Shares purchased of FMV of Rs. 45,000 from Mr. Y, for Rs. 25,000. The aggregate receipts exceed Rs. 50,000 [Rs. 45,000 + Rs. 20,000 (the difference)]. However, individually, they are below Rs. 50,000 and therefore would not constitute income. For the purpose of finding out whether the receipt is in excess of Rs. 50,000, the clause does not require aggregation of the different receipts, taxable under different sub-clauses.

- ◆ Where gift is received before as well as after 1-6-2010, a question could arise about aggregation and/or taxability thereof. For the purpose, consider the following illustration:
- ◆ A Ltd. has received the Shares having FMV of Rs. 45,000 on 30-4-2010. It also receives the Shares having FMV of Rs. 45,000 on 11-7-2010. Would it be liable to tax? *Prima facie*: No, for the following reasons:
 - ◆ (a) The Clause lists income chargeable to tax under the head 'Income from other sources'.
 - ◆ (b) Clause (viii) (i) treats any Shares received without consideration in aggregate exceeding Rs. 50,000 as income, if received on or after 1-6-2010.
 - ◆ (c) If the amount received is less than Rs. 50,000 during the period 1-6-2010 till 31-3-2011, it would not constitute income.
 - ◆ Having regard to the above, it appears that the Shares received having FMV of less than Rs. 50,000 during the financial year, do not answer the description of income as given in the Clause and, therefore, not liable to tax.

FAIR MARKET VALUE

- ◆ It is defined to mean value determined as per the method as may be prescribed.
- ◆ For determination of value, the benchmark is FMV.
- ◆ FMV is defined by *Explanation* below section 56(2) (vii), by reference to *Explanation (b)* below section 56(2)(vii) to mean value as per prescribed method.
- ◆ For the purposes of section 56 of the Act, Sub-Part H of the Income-tax Rules, 1962 lays down the methods for '*Determination of fair market value of the property other than immovable property*'

- ◆ **RULE PRESCRIBING METHOD** - Rule 11 UA of the Rules, *inter alia*, prescribes the method for 'Determination of fair market value' of unquoted equity shares. The rule prescribes a method, popularly known as break-up value method (based on asset backing or net worth) for determining FMV of the Shares
- ◆ The formula and the components thereof are explained as follows in Rule 11 UA:

FMV of unquoted equity shares and unquoted preference shares shall be the value on the date when such shares are received and shall be determined in the following manner:

FMV of unlisted equity shares $\frac{(A-L)* (PV)}{(PE)}$

A Book value of the assets in Balance Sheet as reduced by:

any Amount paid as Advance Tax under I.T. Act.

and any amount shown in Balance Sheet including the debit balance of the profit and loss account or profit and loss appropriation account which does not represent the value of any asset

L Book value of liabilities shown in the Balance Sheet but not including the following amounts:

- i) the paid-up capital in respect of equity shares
- ii) the amount set apart for payment of dividends on equity and preference shares, where such dividends have not been declared before the date of transfer at a general body meeting of the company
- iii) reserves, by whatever name called, other than those set apart towards depreciation.
- iv) credit balance of Profit and loss.

v) any amount representing provision for taxation, other than amount paid as advance tax under the Act, to the extent of excess over the tax payable with reference to book profits in accordance with the law applicable thereto;

vi) any amount representing provisions made for meeting liabilities other than ascertained liabilities.

vii) any amount representing contingent liabilities other than arrears of dividends payable in respect of cumulative preference shares

PE= Total amount of paid up equity share capital as shown in the Balance Sheet

PV = The paid up value of such equity shares

- ◆ For application of the method, the Sub-Part, *inter alia*, defines the following:
- ◆ Balance sheet, to mean "*the balance sheet of such company (including the notes annexed thereto and forming part of the accounts) as drawn upon the valuation date*" [Rule 11 U(b)];
- ◆ Unquoted shares and securities to mean "*shares and securities which is not a quoted shares or securities*" [Rule 11 U(i)];
- ◆ Quoted shares or securities to mean "*a share or security quoted on any recognised exchange with regularity from time to time, where the quotations of such shares or securities are based on current transaction made in the ordinary course of business*" [Rule 11 U(d)]; and
- ◆ Valuation date to mean "*the date on which the respective property is received by the assessee*" [Rule 11 U(j)].

FMV of unquoted Preference Shares

Price at which it is sold in the open market. The valuation of such shares needs to be certified by report of a Merchant Banker or an Accountant

Merchant Banker –means category I merchant banker registered with Security and Exchange Board of India established under section 3 of the Securities and Exchange Board Of India Act, 1956 (15 of 1956).

Accountant – means a chartered accountant within the meaning of the Chartered Accountants Act, 1949 (38 of 1949, and includes, in relation to any State, any person who by virtue of the provisions of sub-section 2 of section 226 of the Companies Act, 1956 (1 of 1956), is entitled to be appointed to act as an auditor of companies registered in that State.

EXCEPTIONS TO CHARGEABILITY

Receipt of shares under certain transaction would be exempt. This is provided in the proviso to the clause (viia), which reads:

“Provided that this clause shall not apply to any such property received by way of transaction not regarded as transfer under clause (via) or clause (vic) or clause (vicb) or clause (vid) or clause (vii) of section 47”. Accordingly, shares received on account of the following transactions would not be liable to tax.

Any transfer of a capital asset being share or shares held in an Indian company in a scheme of amalgamation by the amalgamating foreign company to the amalgamated foreign company, subject to the satisfaction of conditions - Section 47(via) of the Act

Any transfer of a capital asset being share in an Indian company in a scheme of demerger by the demerged foreign company to resulting foreign company subject to the satisfaction of conditions – Section 47(vic) of the Act

In case of business reorganization, where the shareholder is allotted any share or shares being a capital asset in the successor co-operative bank for the shares held by him in the predecessor co-operative bank – Section 47(vicb) of the Act

In case of demerger, any issue of shares by a resulting company to the shareholders of the demerged company, where shares are issued as a consideration for demerger- Section 47(vid) of the Act

In a scheme of amalgamation, where a shareholder of amalgamating company gets a share being a capital asset of the amalgamated company, provided the amalgamated company is an Indian company- Section 47(vii) of the Act.

The above are some of the transaction forming part of section 47 of the Act. Section 47 excludes the gains from certain transactions from the ambit of capital gains as the said transactions could not be regarded as transfer which is one of the preconditions of section 45. With the specific reference to such transactions now incorporated into section 56(2)(viia), the transferee would also enjoy the exemption.

Section 56(1) of the Act says “Income of every kind which is not to be excluded from the total income under this Act shall be chargeable to income-tax under the head “Income from Other Sources”, if it is not chargeable to income-tax under any of the heads specified in section 14, items A to E”. Thus, the residuary head of income can be resorted to only if none of the specific heads is applicable to the income in question. If a certain item of income is taxable under one of the specific heads, the charge under the head exhausts the taxability of the income, and no part of such income can be brought to charge again under the residuary head.

In the following decisions, the same view has been upheld:

- a. House of Lords in *Salisbury House Estate Ltd v Fry* -15 TC 266
- b. *Nalinikant Mody v Narayan Row* - 61 ITR 428 (SC)
- c. *Bihar State Bank v CIT* – 39 ITR 114 (SC)
- d. *CIT v Basantrai Takhat Singh* – 1 ITR 197

SPECIFIC TRANSACTIONS

Bonus shares or Right shares

Take an example where a company issues bonus shares or makes right issue to its shareholder. A company or firm as a shareholder would receive such bonus shares/ right shares. The question for consideration is whether the same would be taxable?

The receipt of shares is no doubt a pre-requisite for being taxed. However, such shares should be the property of the person from whom it is received. Bonus shares of the issuing company cannot be regarded as its property. Such shares are not reflected on the asset side of its Balance Sheet. The qualifying attribute of the asset moving being a property of the giver would not be satisfied. The giver should have held such shares as assets (reflected in its Balance Sheet either as investments or as stock-in-trade). When such shares are received by a target assessee, the same would not be taxable, even if received for inadequate or no consideration.

The Supreme Court explained 'bonus shares in *Khoday Distilleries Ltd. v. CIT* [2008] 307 ITR 312/[2009] 176 Taxman 142, based on its earlier decisions and other decisions. The gist is as under:

- ◆ In substance bonus shares represent capitalization of the profits and the right to receive profits embedded in the shares fructifies into the bonus shares. In other words, the shareholder receives something, which always belonged to him. To put it differently, it cannot be said that the shares are received from the company. In other words, realization of pre-existing rights cannot be regarded as receipts. In any case, creation and issue of shares do not constitute transfer by the company and accordingly the receipts by the shareholder.

Investor to Investor

56 (2) (viiia) applies as there are 3 Parties i.e. Giver, receiver & the shares of co, not being a co in which public are substantially interested

Issuing co to Investor

56 (2) (viiia) does not apply as there are 2 Parties i.e. Issuing Company and Investor.

Investor N(P) LTD

56 (2)(viiia)
Applies

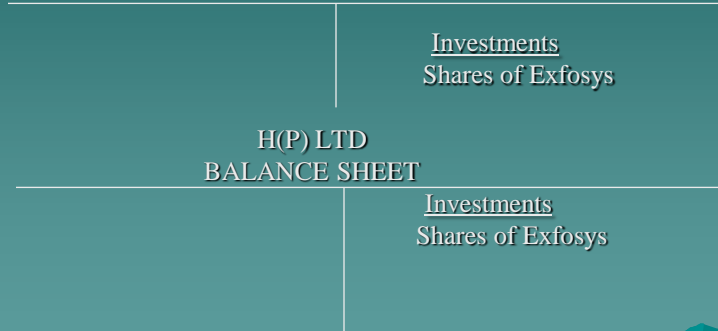
Investor H(P)Ltd

Issuing company Exfosys

Original Shares

Bonus Shares 56 (2)
(viiia) does not apply)

ORIGINAL SHARES
N(P) LTD
BALANCE SHEET



BONUS SHARES
EXFOSYS BALANCE SHEET

Share Capital

Reserve & Surplus



BALANCE SHEET H (P) LTD

INVESTMENTS

EXFOSYS (NO OF
SHARES HAS
INCREASED)

- ◆ Rights shares
- ◆ Rights shares, so popularly referred, represent entitlement to the further issue of capital by a company, by way of inherent right. Section 81 of the Companies Act, 1956 so provides for any issue of shares (by a company), after expiry of two years from formation of a company or at any time after expiry of one year from the first allotment of shares, and lays down that:
 - ◆ "such further shares shall be offered to the persons who, at the time of the offer, are holders of the equity shares of the company, **in proportion**, as nearly as circumstances admit, to the capital paid-up on those shares at that date." (*Emphasis supplied*).

- ◆ Thus, in substance, rights shares represent right to receive further shares, which fructifies into issue and allotment thereof. In other words, the shareholder is allotted further shares, in terms of his pre-existing rights. Realization of pre-existing rights cannot be regarded as receipts. Further, allotment of rights shares, as such, does not affect the proportional interest, as also it does not have impact on the overall value of the holding of a shareholder. In any case, creation and issue of shares do not constitute a transfer by the company and accordingly the receipts by the shareholder

Holding - Subsidiary Transactions

If Holding/Subsidiary company transfers shares (reflected on the asset side of its Balance Sheet) in the nature of capital asset, any gains arising from such transfer is not liable to capital gain tax by virtue of section 47 (iv)/(v) of the Act. If however, if the shares transferred are in the nature of stock-in-trade, the exemption would not apply. For the recipient company, the shares being assets in the nature of stock-in-trade would be taxable, if received for inadequate or no consideration.

Convertible Debentures

- ◆ In case of *convertible* debentures, it is recognized that there exists a pre-existing right to the asset forming part thereof.
- ◆ Typically, in case of *convertible* debentures, essentially, amount is *placed* with a company earning interest or a right to convert at a specified price in future. That is the agreement between the company and debenture *holder*.
- ◆ Pursuant thereto, on date of *conversion*, the debenture is automatically converted into shares at predetermined price, pursuant to exercise of right either by the company or by the *shareholder*.

- ◆ The transaction is not in respect of the shares. It is in respect of the debenture to which the *Clause* does not *apply*.
- ◆ Further, the agreement is not for the transfer and receipt of shares, In that case, as such, upon exercise of the option, the company creates shares out of its own subscribed capital and *allots* it to the *shareholders*.
- ◆ In case of receipt of the shares, pursuant to the pre-existing rights, it cannot be said that it is in the nature of receipt as *contemplated* by the *Clause*. *Accordingly*, it *should* not be *liable* to tax either under *clause (vii)* or *clause (viii)* of section 56(2).

Conversion of firm/proprietary concern into company

If a firm/ proprietary concern holds property in the nature of share of closely held company and in the process of such conversion into company/firm or company, all the assets of firm/proprietary concern becomes the asset of the company/firm or company. On such conversion, if such share being the property of firm or proprietary concern is received by the company at less than the specified value, would this get covered under the proposed new clause (viiia) to section 56(2)?

Under the existing section 47(xiii) and (xiv) of the Act, on conversion of firm into company, proprietary concern succeeded by company, any gain arising on transfer of capital asset or intangible asset is exempt. The exemption is available for the transferor. Under proposed clause (viiia) the transferee is the target assessee. The receipt of shares either for inadequate consideration or without consideration would invite a tax liability. If however, the transfer of undertaking is for a stamp price and no consideration is specifically attributed to the shares, this tax liability may be provided on grounds of the computation provision failing.

CONVERSION OF A FIRM INTO A COMPANY

Upon conversion of a firm into a company under Part IX of the Companies Act, 1956, the property vests in the company, without doing anything further. The Mumbai High Court has held in *CIT v. Texspin Engg. & Mfg. Works* [2003] 263 ITR 345/129 Taxman 1 that there is no transfer and it observed as follows:

" ... we are concerned with a partnership firm being treated as a company under the statutory provisions of Part IX of the Companies Act. In such cases, the company succeeds the firm. Generally, in the case of a transfer of a capital asset, two important ingredients are: existence of a party and a counterparty and, secondly, incoming consideration qua the transferor. In our view, when a firm is treated as a company, the said two conditions are not attracted. " (Emphasis supplied)

Partner introducing shares as his capital contribution

A partner may contribute shares of a closely held company as his capital contribution on becoming partner of firm, whether such a transaction would be covered within section 56(2)(viiia) of the Act?

Any partner bringing in any capital asset as his capital contribution was regarded as 'transfer' triggering capital gains tax. The amount recorded in the books of account of the firm was taken as the 'consideration' on such transfer. Thus, the resulting capital gain was taxable in the hands of the partner.

In the light of proposed clause (viiia), the question for consideration is whether the partner bringing in shares of a closely held company as his contribution towards capital would be covered under the proposed law?

When a partner brings in shares of a closely held company, as his capital contribution at a value below the prevailing market price, the same would get covered under the proposed clause (viiia). On receiving such shares, the firm being target assessee would be liable to tax.

Shares inherited by firm or company

Under the current provisions of section 56(2) (vii) of the Act (applicable to an individual or a HUF) a specific exclusion is given where any property is received under will or by way or inheritance. The same is not subjected to tax. Under the proposed clause (viiia), there is no specific exclusion on account of will or inheritance. In case of firm or company receiving any shares of closely held company through a will would technically get covered within the ambit of proposed clause (viiia).

It may have to be argued that there is no transfer but only transmission of shares in such eventuality. As a result the basic postulate of section 56(2) of the Act (receipt of shares) is not satisfied. The specific exemption to an individual or HUF is possibly out of abundant caution as even otherwise, the said transaction may not have fallen within the new section.

Shares (being asset) distributed on liquidation of company or shares (being asset) distributed on dissolution of firm

A shareholder on liquidation of company receives any capital asset from the company. The shareholder would be liable for the capital gains under section 46(2) of the Act. If during the liquidation, the shareholder receives shares of closely held company for inadequate consideration, then by virtue of the proposed clause (viiia), the same would be subjected to tax. The inadequacy for the purpose should have to be determined under the method specified. Inadequacy may be income if the value adopted for charging tax under section 46(2) of the Act is lower than that which is arrived at for section 56(2)(viiia).

If a firm is dissolved, distribution of asset to its partners is regarded as transfer by virtue of section 45(4) of the Act. The market value of such asset would be regarded as the full value of consideration. For the reasons already discussed, the asset being shares of closely held company on distribution consequent to dissolution if received for inadequate consideration will attract tax.

- ◆ Cost of acquisition
- ◆ Section 49(4) of the Act provides for determining cost of acquisition of property (received without consideration or lower consideration) value whereof is taxed under the Clause. The value taken into account for the purposes of the Clause shall be deemed to be its cost.
- ◆ To illustrate:
- ◆ (a) A Ltd. has received the Shares without consideration. FMV thereof is, say, Rs. 100,000. It has paid tax thereon under the Clause. It sells the said shares for Rs. 125,000. For the purposes of computing capital gains, the cost of acquisition, in terms of the said provision, would be Rs. 100,000.

- ◆ Accordingly, the capital gains would be Rs. 25,000 (subject to applicability of indexed cost of acquisition).
- ◆ (b) A Ltd. has purchased the Shares for Rs. 500,000. FMV thereof is Rs. 600,000. On the difference, it has paid tax under the Clause. It sells the same for Rs. 750,000. For computing capital gains, the cost of acquisition, in terms of the said provision, would be Rs. 600,000 being the value considered for the purposes of the Clause.

- ◆ As said above, the value taxed under the Clause is adopted as cost and hence wherever applicable such cost can be indexed in terms of the provisions of the Act. It appears that the period of holding will have to be determined with reference to the date of receipt and, in particular, having regard to section 49(4).
- ◆ For the purposes of computation of business income, the law is silent and there is no specific provision, like, section 49(4) providing for substitution of the value of property adopted for taxation under the Clause.