CBDT clarifies that section 56(2)(viia) does not apply to receipt of shares on issuance by closely held companies

Background

The Finance Act, 2010 amended section 56(2) of the Income-tax Act, 1961 ('the Act'), by adding clause(viia) to provide that where a firm or closely held company (i.e. a company not being a company in which the public are substantially interested) receives shares of another closely held company, without consideration or for a consideration less that the fair value of the shares, the difference would be chargeable to tax in the hands of the receiving company as income from other sources. The Memorandum to the Finance Bill, 2010 noted that the provision was a measure for the prevention of the practice of *'transferring'* unlisted shares at prices much below their fair market value.

In view of the apparent conflict between the stated intention (which talks of '*transferring*' of shares) and the law (which talks of shares being *received*), there was uncertainty as to whether the provision would apply to new issue of shares, rights and bonus shares. The Tribunal[1] has in the recent past held in the case of rights shares, the provisions would not be applicable where the rights are issued on a proportionate basis.

Central Board of Direct Tax (CBDT) circular

The CBDT has recently issued a circular[2] acknowledging that the term 'receives' is wider and could lead to taxation of transaction pertaining to issuance of new shares including by way of right shares, bonus shares, preference shares or transactions of similar nature. Considering the intention behind the introduction of the provision, the circular provides that section 56(2)(viia) will not apply to cases of receipt of shares by firms or closely held companies as a result of fresh issuance of shares in the cases mentioned above.

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[1] *Shri Subhodh Menon - TS-718 ITAT-2018(Mum); Sudhir Menon (HUF) - TS-146-ITAT-2014(Mum)*

[2] *Circular No 10/ 2018 dated 31 December 2018*

Dhruva Comments

This Circular provides clarity as to the applicability of section 56(2)(viia) upon the issuance of new shares by closely held companies. Pending litigation on this issue can now be resolved accordingly.

The provisions of section 56(2)(viia) were replaced in 2017 by the Finance Act, 2017 by a more comprehensive provision (i.e. section 56(2)(x)) dealing with receipt of various kinds of property without consideration or for inadequate consideration. The Circular does not deal with the applicability of this new provision to fresh issuances of shares.

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