Taxability of 'Rights Issue' u/s. 56(2)(x) : The 'Right' Way Forward.....

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Introduction

One of the common practices adopted by companies to gain two-fold advantages i.e. meeting fund requirements without diluting the voting power, is issuing equity shares to companies' existing shareholders. In legal terminology, this is called 'rights issue'.To make rights issue lucrative, companies tend to issue shares at a price less than fair market value. In such cases, whereinexisting shareholders receive the shares at a price less than fair market value, there arises a possibility of applicability of income tax under the provisions of Income Tax Act, 1961 (“***Act***”). Thus, in the present note, an attempt has been made to analyze the probableincome tax implicationswhich may arise during a rights issue.

Understanding the Legal Provision

As per section 56(2)(x) of the Act, any receipt of property (which also includes shares) without consideration or for a consideration which is less than its fair market value computed in accordance to the prescribed rules (“***Tax FMV***”) by an amount exceeding Rs. 50,000/-, then difference between the fair market value and purchase consideration (if any), shall be treated as income in the hands of recipient. From the plain language of section 56(2)(x), it appears that issue of right shares where shareholder receives shares at a price less than Tax FMV, shall trigger the applicability of the said section. However, one should appreciate as to whether it is the intent of the legislature to tax the issue of right shares u/s 56(2)(x) where right shares are 'ordinarily' issued at discount in comparison to the Tax FMV. To ascertain the same, provision of section 56(2)(x) of the Act is analyzedbelow in detail:

1. **Purposive Interpretation**:Clauses(v)/(vi)/(vii)/(viia)/(x) of section 56(2) of the Act were introduced (time to time) as a counter evasion mechanism[1] to curb the practices of bogus capital building and money laundering. Accordingly, taxing issue of right shares u/s 56(2)(x) which are ordinarily issued at discountin comparison to the prevailing fair market value to infuse capital in the company in the ordinary course of its business, shall be against the legislative mandate.

2. **Meaning of Consideration**: For triggering the applicability of section 56(2)(x), there should be receipt of sharesfor a 'consideration' less than Tax FMV.Term 'consideration' is not defined in the Act. Dictionary[2] meaning of term 'consideration' suggests that it includes the cases where loss or detriment is suffered in lieu/exchange of something. In case of issue of right shares, gain arising to the shareholder pursuant to receipt of right shares at a price less than Tax FMV shall be offset by fall in the value of existing shares. Similar view has also been given by the Hon'ble ITAT[3]Accordingly, it can be said that in consideration of deprecation in value of existing shares, recipients are issued the right shares at a price less than Tax FMV.This is further illustrated with the example below:

Before issue of right shares, 10,000 sharesheld by **A&B** in the ratio of 60:40 were valued at Tax FMV of Rs. 400/- each. Company announced 1:2 right issue at a price of Rs. 100/-. Post right issue, Tax FMV of the Company reduced to Rs. 300/- per shares. Resultantly, right shares, Tax FMV of which is Rs. 300/- post right issue has been received at a price of Rs. 100/-, whereas, Tax FMV of existing shares has been reduced from Rs. 400/- to Rs. 300/-. Accordingly,in this case, gain arising of Rs. 6 Lakh pursuant to receipt of shares by Mr. A for lesser consideration [Rs. 200/- per share *3,000 shares) shall be offset by decline in value of existing shares amounting to Rs. 6 Lakh(Rs. 100/- per share *6,000 shares).

3. **Cost of Acquisition of right shares**:As per section 55(2)(aa)(iii) of the Act, where by virtue of holding shares, assessee is entitled to additional financial asset being shares (i.e. right shares), then cost of acquisition of such additional shares being right shares shall be the amount actually paid for acquiring them (Rs. 100/- as per the above example). Whereas, as per the provision of section 49(4) of the Act, in case receipt of any capital asset has been subject to tax u/s 56(2)(x), then cost of acquisition of such capital asset shall be the valuetaken into account for the purpose of section 56(2)(x). Now, if receipt of right shares is subject to taxation u/s 56(2)(x), then shareholder would pay tax on the differential value of Tax FMV (Rs. 300 as per the above example) and issue price (Rs. 100 as per the above example), then accordingly, cost of acquisition of such right shares should be determined u/s 49(4) (Rs. 300/- as per the above example) to avoid any double tax implication at the time of sale of right shares by the shareholder. However, it would lead to a scenario where Section 55(2)(aa)(iii) of the Act would become totally redundant, which would never have been the intent of the legislature.

4. **Concept of Real Income**: It is a settled principle[4] under the Act that only real income can be taxed, not hypothetical income. In case of issue of right shares, gain arising pursuant to receipt of right shares shall offset by decline in value of existing shares. Resultantly, assessee's wealth does not get increased by receiptof right shares and it remains intact. Meaning thereby, assessee has not earned anything from receipt of right shares. Though, there is a deeming provision in the definition of 'income' provided u/s 2(24) of the Act which states that income includes value of property referred to in section 56(2)(x), however, such deemed income in relation to receipt of right shares may at best be considered as hypothetical income, which can't be taxed.

From the above it is evident that taxing receipt of right shares u/s 56(2)(x) could not be a legislative intent. However, literal interpretation of section 56(2)(x) suggests its applicability upon shareholders on receipt of right shares at a price less than Tax FMV. In such cases, whenever literal interpretation leads to unreasonable and absurd consequences, Hon'ble Supreme Court[5]has categorically ruled that such literal interpretation should be avoided.

Point of Caution

At this juncture, it is also relevant to note that certain companies resort to practice of right issuefor transferring its ownership/control at a price less than prevailing market value by issuing shares disproportionate to the existing shareholding. The same can be understood with the help of certain modifications in the example as discussed above. Now, if Mr. B decides not to subscribe the right shares and Mr. A was given the offer to subscribe those right shares, then shareholding proportion of Mr. A and Mr. B would be changed from 60:40 to 73.33:26.67. Further, in such case, Mr. A, by subscribing to right shares for Rs. 5,00,000/- (5000 shares * Rs. 100) has increased his wealth from Rs. 24 lakhs (6000 shares * Rs. 400) to Rs. 33 Lakh (11000 shares * Rs. 300). Accordingly, Mr. A has increased his wealth by Rs. 9 Lakh after making payment of lesser consideration of Rs. 5 Lakh. Therefore, real income of Mr. A is Rs. 4 Lakh in the instant case and that should be the amount which should be taxed u/s 56(2)(x) of the Act. Accordingly, in case of disproportionate allotment of right shares, receipt of right shares by the shareholder in excess of his proportionate entitlement should be taxed u/s 56(2)(x) of the IT Act (2000 shares * Rs. 200 per share differential value = Rs. 4 Lakh as discussed above).

Conclusion

In view of the above, one sound view is that no tax should be applicable on receipt of right shares at a price less than Tax FMV, u/s 56(2)(x) of the Act where right shares are allotted to shareholders in proportion to their existing shareholdings.However, cases of disproportionate allotment of rights shares, in view of the caution stated above, shall be hit by the rigor of the provisions of Section 56(2)(x) of the Act.

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[1]Finance Minister's Speech, Union Budget 2004-05; Circular No. 05/2005 [Explanatory Notes on provisions relating to Direct Taxes: Finance (No. 2) Act, 2004]; Circular No. 01/2011 (Explanatory notes to theprovisions of theFinance Act, 2010)

[2]Black's Law Dictionary, Sixth Edition

[3]Sudhir Menon (HUF) v. ACIT [2014] 148 ITD 260 / [TS-146-ITAT-2014(MUM)-O] (Mumbai Trib.)[Department's appeal (ITA No. 712/2015) against the said judgment has been admitted before Hon'ble Bombay High Court vide order dated 05.09.2018).

[4]CIT v. ShoorjiVallabhdas& Co. [1962] 46 ITR 144 (SC)

[5]K.P. Varghese v. ITO [1981] 131 ITR 597 (SC) / [TS-11-SC-1981-O]