

Share allotment under 'rights issue' not taxable u/s. 56(2)(vii)(c) if shareholders were relatives : ITAT

Summary – The Visakhapatnam ITAT in a recent case of Kumar Pappu Singh, (the Assessee) held that Transactions between close relatives are outside scope of application of section 56(2)(vii)(c)

Facts

- The assessee was shareholder in company, JMPP and held 76 per cent of the total shareholding. There were total seven share holders in the company and all of them were close relatives either legal ascendants or descendants. The company had issued 1,50,000 shares at rate of Rs. 100 per share under rights issue. The assessee alone had applied for rights issue and received shares from JMPP. The fair market value of the shares was at Rs. 416.38 per share. Thus, the assessee paid less than the fair market value for acquisition of shares. Accordingly the Pr. Commissioner observed that the income was short computed which was chargeable to tax under section 56(2)(vii)(c). He, further, observed that the assessee himself had received the entire enhanced equity of the company under the rights issue and the other seven shareholders did not receive any shares from the enhanced share capital of the company. This allotment resulted in increase in the assessee's shareholding in the company to 91 per cent from the earlier shareholding of 76 per cent. Such increase in the assessee's holding resulted in simultaneous diminution in the holding of the other shareholders and the rights in the company to the same ratio. Thus, the Pr. Commissioner viewed that the assessee had clearly received tangible property in the form of shares for a consideration which was less than the fair market value of the property which also increased his rights over the company.
- In instant appeal the assessee contended that, all the shareholders of the company were close relatives of the assessee with the relationship of wife, daughter, sister, brother and son and the transaction was between the close relatives. For the transactions between the close relatives, section 56(2)(vii)(c) had no application as per the Act.

Held

- The assessee submitted that there was no other applicant for the shares under the rights issue, hence, the company had allotted the excess shares to the assessee over and above his entitlement to his proportionate to the shareholding. The assessee submitted that all the shareholders in the company are close relatives and the proviso to section 56(2)(vii)(c) is not applicable in the case of close relatives. The assessee brought to notice that the remaining shareholders are brothers, sisters, son, daughter, wife etc. The company is closely held company and all the shareholders are legal ascendants or descendants as defined in the Act under close relatives.
- The assessee has only applied for shares which were allotted by the company. The contention of the revenue is that since there is no relation between the company and the assessee there is no case for invoking the explanation of relative to exempt the assessee from taxing the excess fair market value

under the head 'income from other sources'. Whereas, the contention of the assessee is that all the shareholders are relatives. The transaction between the close relatives is not taxable under the head 'income from other sources' under section 56(2) and hence, the section 56(2)(vii)(c) has no application. One has gone through the provisions of section 56(2)(vii)(c) and this provision was brought as an anti-abuse measure, seeks to tax the understatement in consideration as the income in the hands of the recipient (of the corresponding asset) as against the donor in the case of *Gift Tax Act*. The transactions between the close relatives are outside the scope of application of section 56(2)(vii)(c). The legislature in its wisdom excluded the transaction of close relatives for the purpose of taxation under the income from other sources. Even the gifts received from the close relatives under section 56(2)(v) are outside the scope of section 56(2). Though the shares are allotted to the assessee, the entire shareholding of the company is retained by the family and no share was allotted to the outsiders. In this case, though the assessee had received the excess shares, renouncement was from the close relatives and the assessee is at liberty to transfer the shares to other relatives or shareholders at any point of time without attracting the taxation under section 56(2)(vii)(c). Therefore, surrender of the rights of the close relatives in favour of the another close relative is covered for exemption under section 56(2)(vii)(c). The transaction is within the family and close relatives and covered by the proviso to section 56(2)(vii)(c) and there is no application of the said section for taxing the income under the head 'income from other sources'.

- In the instant case, all the shareholders are the relatives within the meaning of proviso to section 56(2)(vii)(c). Therefore, the excess shares allotted to the assessee, there is no case for application of section 56(2)(vii)(c), accordingly, the order of the Pr. Commissioner is set aside and the appeal of the assessee is allowed.