

## **Issue of shares to director to comply with a covenant in loan agreement with bank couldn't be taxed u/s 56(2)(vii)**

**Summary – The Mumbai ITAT in a recent case of Subhodh Menon, (the Assessee) held that where transaction of issue of shares to assessee i.e Director and Promoter of company 'D', was carried out to comply with a covenant in loan agreement with bank to fund acquisition of business by subsidiary of company 'D' in USA, such a bona fide business transaction could not be taxed under section 56(2)(vii) especially when there was not even a whisper about money laundering by Assessing Officer in assessment order**

### **Facts**

- The assessee was one of the promoters and directors of a company namely, 'D' Ltd. on 1-4-2009 the assessee held 34.57 per cent of the total issued share capital of the company. The company had a wholly owned subsidiary in USA.
- During the year under consideration, the subsidiary intended to acquire the chemical business of another US based company. To finance the acquisition, the subsidiary entered into a loan agreement. The loan agreement required the promoters of the 'D' Ltd. to increase the total net worth of the company to Rs. 150 crores by 31-3-2010.
- In order to comply with said covenant in the loan agreement, the board of directors of the company passed a resolution on 7-9-2009 to issue 63 lakhs shares at the face value of Rs 100 to the existing shareholders in proportion to their holding in the company so as to increase the share capital by Rs 63 crores.
- On the same day, 7-9-2009 an offer letter was circulated by the company to the existing shareholders. Based on the existing shareholding of 34.57 per cent, the assessee was offered 21.78 lakhs shares at face value of Rs. 100. The assessee accepted the part offer of the shares of only to the extent of 20.94 lakhs shares. On 21-9-2009 the company informed its shareholders about the acceptance by them of the shares offered by the company.
- The shares were formally allotted by the company on 28-1-2010 pursuant to the acceptance by the shareholders of the offer made to them in September, 2009. As the assessee only partly accepted the shares offered to him, his shareholding came down from 34.57 per cent to 33.30 per cent. Post the acceptance by the shareholders of the company of the shares offered to them by the company the value of each share of the company was determined at Rs. 184 per share.
- The assessee filed his return of income for the assessment year 2010-11 declaring certain taxable income. The Assessing Officer passed an order under section 143(3) making an addition of Rs. 301.25 crores under section 56(2)(vii).
- The Commissioner (Appeals), however, taking a view that provisions of section 56(2)(vii) did not apply to assessee's case, deleted addition made by Assessing Officer.
- On revenue's appeal:

## Held

- The provisions of section 56(2)(vii) do not apply to *bona fide* business transaction. In the instant case, shares were issued by the company to comply with a covenant in the loan agreement with State Bank of India which required the promoters to increase the total net worth of the company to Rs. 150 crores by 31 March, 2010. Therefore, the shares were issued by the company for a *bona fide* reason and as a matter of business exigency. Circular No.1/2011 dated 6 April, 2011 issued by the CBDT explaining the provision of section 56(2)(vii) specifically states that the section was inserted as a counter evasion mechanism to prevent money laundering of unaccounted income.
- In the instant case, the transaction of issue of shares was carried out to comply with a covenant in the loan agreement with the bank to fund the acquisition of the business by the subsidiary in USA, such a *bona fide* business transaction could not be taxed under section 56(2)(vii) especially when there was not even a whisper about money laundering by the Assessing Officer in the assessment order.
- In view of the above, the provisions of section 56(2)(vii) cannot be applied to transaction under consideration.
- Moreover, the provisions of section 56(2)(vii) are applicable only from 1-10-2009. In the instant case, the offer was made by the company to the shareholders to subscribe for the shares on 7-9-2009 pursuant to resolution passed by board of directors on the same date. Further, on 21-9-2009, the company informed the shareholders about the acceptance of shares offered by the company. Therefore, the offer made by the company was accepted by the shareholders before 1-10-2009 hence, the contract between the company and the shareholder for issue by the company of shares was completed before 1-10-2009. Accordingly, the provisions of section 56(2)(vii) do not apply to as the contract was executed prior to 1-10-2009. It was only the formal routine act of issuance of the share certificate by the company which took place after 1-10-2009. The revenue has also relied on the provisions of section 17 that there would be a tax liability under section 17, even if section 56(2)(vii) does not apply, as the assessee being an employee of the company. The allotment of shares by the company the holding of the assessee came down from 34.57 per cent to 33.30 per cent, *i.e.*, shareholding of the assessee witnessed a decline after the shares were allotted by the company, no benefit was received by the assessee and therefore, even the provisions of section 17 were not applicable.
- Furthermore, the provisions of section 17 do not apply to the shares allotted by the company to the assessee as the shares were not allotted by the company to the assessee in his capacity of being an employee of the company. The shares were offered and allotted to the assessee by the company by virtue of the assessee being a shareholder of the company. Therefore the provisions of section 17 are not applicable. Circular No. 710 dated 24-7-1995 also supports the assessee's stand that where shares are offered by company to a shareholder, who happens to be an employee of the company at the same price as have been offered to other shareholders or the general public, there will be no

perquisite in the shareholder's hands. In the instant case, the shares were offered to the assessee and other shareholders at a uniform rate of Rs. 100 and therefore, the difference between the fair market value and issue price cannot be brought to tax as a perquisite under section 17 of the Act.

- In view of the above, there is no infirmity in the order of Commissioner (Appeals).
- In the result appeal of the revenue is dismissed.