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Withdrawal of Circular No. 10/2018 on applicability of section 56(2)(viiia)



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Introduction

1. As per section [56\(2\)\(viiia\)](#) of the Income Tax Act, 1961 (Act), where a company in which public are not substantially interested (specified company) or a firm receives, in any previous year, from a person or persons, shares of a specified company, without consideration and the aggregate FMV of such shares received during a previous year exceeds Rs. 50,000 or the shares are received for a consideration which is less than the FMV and the aggregate of differences between FMV and consideration of all such shares received during a previous year exceeds Rs. 50,000, then such difference is taxable as income under the head 'income from other sources' in the hands of firm or company. Section 2(18) provides the definition of a company in which the public are substantially interested.

The aforesaid provision has been introduced by the Finance Act, 2010 and vide memorandum explaining the bill, it has been explained that in order to prevent the practice of transferring unlisted shares at prices much below their fair market value, it is proposed to amend section 56 to include within its ambit transactions undertaken in shares of a specified company either for inadequate consideration or without consideration where the recipient is a firm or a specified company.

There has been an ambiguity in the meaning of term "receives" used in section 56(2)(viiia) of the Act. This has led to tax controversy in the many cases where the shares are received as a result of buyback of shares or as a result of fresh issuance of shares (including by way of issue of bonus shares, rights shares, preference shares, etc).

CBDT Clarification

2. The Central Board of Direct Taxes (CBDT), taking note of the above, vide [Circular No. 10/2018, dated 31.12.2018](#), has clarified that the term "receives" used in section 56(2)(viiia) of the Act, will not include shares received by firm or specified company as a result of fresh issuance of shares, including by way of issue

of bonus shares, rights shares and preference shares or transactions of similar nature. It was stated in the circular that the intention of Government was never to apply the provisions of the said clause (viiia) to the fresh issuance of shares by the specified company.

However, CBDT vide [Circular No. 02/2019, dated 04.01.2019](#), has now clarified that the matter relating to interpretation of the term "receives" used in section 56(2)(viiia) of the Act is subjudice in certain higher judicial forums. Further, representations have been received from take holders seeking clarification on similar provisions in section 56 of the Act. Accordingly, the matter has been reconsidered by the Board. Given the fact that the matter relating to interpretation of the term 'receives' used in section 56(2)(viiia) of the Act is pending before judicial forums and stakeholders have sought clarifications on similar provisions in section 56 of the Act, the Board is of the view that the matter requires to be examined afresh so that a comprehensive circular on the matter can be issued.

In the light of above, the [Circular No. 10/2018 dated 31st December, 2018](#) stands withdrawn and shall be considered to have never been issued.

Applicability of Section 56(2)(viiia) debatable

3. While the act of first issuing and then withdrawing the circular on the subject has made the applicability of section very debatable, we would like to highlight a few important judgments on related issues.

- ◆ The Hon'ble Apex Court in the case of *CIT v. Dalmia Investment Co. Ltd.* [1964] 52 ITR 567 had in early 1964 held that bonus shares if they ranked *pari passu* with the original shares, had to be valued at average of both bonus and the original shares. Therefore, total value of shares, pre-and post-issue of bonus shares will remain same.
- ◆ The Hon'ble Bangalore Tribunal in the case of *Dy. CIT v. Dr. Rajan Pai* [2017] 82 taxmann.com 347 has held that bonus shares do not result in recipient getting a property without consideration or for inadequate consideration. Total value of equity shares held along with bonus shares remains the same. Thus, any profit derived by the assessee on account of receipt of bonus shares is theoretically offset by the depression in the value of the equity shares already held by him.
- ◆ The Hon'ble Mumbai Tribunal in the case of *Sudhir Menon HUF v. Asstt. CIT* [2014] 45 taxmann.com 176/148 ITD 260 also affirmed the view that right shares and bonus shares are not covered under section 56(2)(vii) of the Act. A consideration has flown out from the holder of the shares, which is reflected in the depression in the intrinsic value of the original shares held by him.
- ◆ In case of *Vora Financial Services (P.) Ltd. v. Asstt. CIT* [2018] 96 taxmann.com 88/171 ITD 646. The Hon'ble Mumbai Tribunal has held that buy back of shares is not covered under the ambit of section 56(2)(viiia). It was observed that for the purpose of taxing buy-back under section 56(2)(viiia), shares should become "property" of recipient-company whereas in case of buy-back, such shares are mandatorily cancelled and cannot become property of a company. Accordingly, buy back of shares should be out of the ambit of section 56(2)(viiia) of the Act.

Concluding Remarks

4. We are looking forward to have a clear circular from CBDT with a comprehensive view. With effect from 01.04.2017, section 56(2)(x) of the Act will substitute section 56(2)(viiia) and scope of section 56(2)(x) is wider than that of section 56(2)(viiia).

