Receipt of Consideration or *Issue of Shares* Fastens Charge under Section 56(2)(viib)?

Section 56(2)(viib) aims at arresting the inflow of black money into the corporate finance. Pricing of equity shares should be commensurate with actual worth. Fair valuation of equity shares is the underlying dictum. Unreasonable or artificial acceleration in share valuation has been sought to be taxed. This incremental valuation has been statutorily roped in as income. Although the objective is clear, the language employed in the Section does not clarify the point of taxation. Though receipt of consideration appears to be the cynosure, it should be accompanied with the issue of shares by the company. The author in this article discusses various perspectives of this Section to provide some lead into the proposition that actual issue of shares is a precondition for triggering the Section 56(2)(viib). Read on…

CA. P. Shivanand Nayak

(The author is a member of the Institute who may be contacted at nayak.ps@gmail.com.)

An issue of shares by a company could be at par, premium or discount. It is a prerogative of the company's directors to decide the quantum of premium and wisdom of the shareholders to subscribe at such premium[1]. *Qua* the issuer company, receipts on issue of shares were always capital and

[1] *Green Infra Limited v ITO (2013) 38 taxmann.com 253 (Mumbai - Trib)*

Section 56(2)(viib) *inter alia* requires an assessee-company to receive any consideration for issue of shares that exceeds the face value of such shares. If the two events of *receipt* (of consideration) and *issue* (of shares) coexist in a particular year, the condition gets automatically satisfied.

hence outside the levy of income-tax. Judiciary has repeatedly concurred with this position. Eventually, it was observed that companies issued shares at a price higher than their actual worth or fair market value. The receipts of funds were often not at arm's length. The legislature sought to tax these fund transfers. The Finance Act, 2012 added the Clause (viib) to Section 56.

Section 56(2)(viib) is applicable to the companies in which public is not substantially interested [*closely-held company*]. It contemplates closely-held companies issuing shares at premium for a consideration exceeding fair value of shares. The differential is taxed as *income from other sources*. The definition of income under Section 2(24) is amended [by inserting clause (xvi)] to include such 'differential' as income. Receipt of securities premium which was hitherto a capital receipt, was characterised as 'income'.

The objective of this provision can be deciphered from a press release dated 16th May 2012 issued by the Central Board of Direct Taxes on the Government's white paper on black money, which clarifies that the objective was to check the introduction of black money in share capital of closely-held companies. Infusion of unaccounted or black money into share capital of a company is statutorily discouraged. It deters the issue of shares at value exceeding fair market value ("FMV").

Section 56(2)(viib) *inter alia* requires an assessee-company to receive any consideration for issue of shares that exceeds the face value of such shares. If the two events of *receipt* (of consideration) and *issue* (of shares) coexist in a particular year, the condition gets automatically satisfied. However, year-end receipt of consideration or issue of shares could often result in the two events falling in different years. The question is in such a case, should primacy be given to *receipt of consideration or issue of shares*? What are the receipts sought to be covered within the Section 56(2)(viib)? These questions require a deeper analysis.

Nature of Receipts Covered by Section 56(2)(viib)

1. Section 56(2)(viib) contemplates receipt of consideration for issue of shares. The phrase *consideration for issue of shares* is not defined in the statute. In the absence of a statutory guidance on this matter, it is critical to understand the scope of this expression. As a part of the share issue process, the company could receive share application money, call money, share premium or advance against allotment. Each of these receipts may not qualify to be *consideration for issue of shares*. Although, all the receipts may culminate in issue of shares, Section 56(2)(viib) does not trigger every time.
2. Section 56(2)(viib) is concerned with the receipt of *share premium* in excess of FMV. This is apparent in the memorandum to the Finance Bill, 2012 and Circular No. 3/2012, dated 12th June 2012 (explaining the provisions of Finance Act, 2012). The section heading in the memorandum [for Section 56(2)(viib)] reads share premium in excess of the fair market value to be treated as income. Further, the Mumbai bench of Income-tax Appellate Tribunal ("ITAT") in the case of *Panna S. Khatau v ITO (2015) 172 TTJ 160 (Mum-ITAT)* held that Section 56(2)(viib), inserted by Finance Act, 2012 to provide for treatment of share premium. The Section therefore does not encompass other forms of receipts in the share issue process.
3. The expression *consideration for issue of share* appears to have a wide meaning on a standalone basis, but its limits are implicit when viewed contextually. A comparative study of Section 56(2)(viib) with *proviso* to Section 68 provides some guidance on this matter. As per the *proviso* to Section 68, any sum credited to company consisting of share application money, share capital or share premium or any such amount by whatever name called may be charged to tax if they remain unexplained. Section 68 deals with share application, share capital, share premium or any such amount by whatever name called. The legislature was within its powers to use similar or identical language in Section 56(2)(viib). Both these provisions were introduced by the Finance Act, 2012. However, the ambit of Section 56(2)(viib) is ring fenced to share premium. Introduction of Section 56(2)(viib) and *proviso* to Section 68 into the statute was

simultaneous. They appear to operate on the same aspect (receipt of monies on issue of shares). However, the spectrum of their applicability is different. It is trite to state that one cannot add words to a statute or read words into it which are not there. The scope of Section 56(2)(viib) should be therefore strictly limited to receipt of share premium and no other receipts can be read into this provision.

4. Section 56(2)(viib) is an anti-abuse provision. It is introduced into the statute with a specific purpose. The objective as explained earlier was to deter capital funding routed through undisclosed sources. Sections 68 and 56(2)(viib) collectively seek to counter black money circulation in company capital structure. Both these Sections fasten tax liability on the company issuing shares. While Section 68 taxes any amount credited to the company if the identity of the person crediting such sum is undisclosed; Section 56(2)(viib) taxes consideration for issue of shares in excess of FMV. No prudent investor would invest funds into a company at a price exceeding its market value. Any excessive funding is always viewed with a suspicious eye by the Revenue authorities as a mechanism to transfer funds. The focus was thus on the incremental receipt of the company. The subject matter is the share premium.

Year of Taxability

As mentioned earlier, if receipt of consideration and issue of shares occur in different years, the year of taxability becomes a matter of debate.

(A) Literal Interpretation

Section 56(2)(viib) mandates receipt of consideration for issue of shares. The legislature employs the proposition *for* before the phrase *issue of shares*. Oxford Dictionary gives out various meanings of the word *for*, which *inter alia* are *by reason of or because of*. Applying this meaning in the present context, Section 56(2)(viib) contemplates the consideration received *because of* or *by reason of* issue of shares. The preposition *for* is used before the verb *issue* and explains the consideration was received for what? The Section presupposes the issue of shares and a concomitant receipt of consideration. Receipt of monies (or in kind) *sans* issue of shares is outside the sweep of Section 56(2)(viib). To state this differently, issue of shares is a *sine qua non* for applicability of the Section 56(2)(viib).

The quantification of income and creation of charge thereon under Section 56(2)(viib) involves value comparisons. The creation of charge involves a two-step comparison. The consideration received by the assessee-company is compared with the face value of shares and then with the FMV.

Multiple comparisons in the Section are unworkable without issue of shares:

I. The quantification of income and creation of charge thereon under Section 56(2)(viib) involves value comparisons. The creation of charge involves a two-step comparison. The consideration received by the assessee-company is compared with the face value of shares and then with the FMV. If the consideration received exceeds both the face value and FMV, a charge under Section 56(2)(viib) is fastened. The closing portion of the Section reads *that exceeds the face value of such shares, the aggregate consideration received for such shares as exceeds the fair market value of the shares*. While enacting the two-stepped comparison, the Section uses the phrase *such shares* on both occasions/comparisons. The phrase *such shares* refers to shares in the opening portion of the Section. It connotes shares issued for consideration. The *issue* of shares is thus a precursor for the comparisons.

II. A share is a share in the share capital of a company. An existence of share presupposes the existence of share capital [*S.N.D.P Yogam, Quilon, Re, (1970) 40 Com Cases 60 (Ker)*]. Use of the term shares in the statute refers to the aliquot portion of the share capital[2]. The value of an instrument is contained in share capital only on shares being actually issued to the subscriber. Till then, they do not form part of the share capital. Thus, use of the term *shares* in Section 56(2)(viib) is indicative of statute visualising status that prevails post the issue of shares. Issue of shares is a perquisite for the applicability of Section 56(2)(viib).

III. Income quantification under Section 56(2)(viib) is based on FMV. The time and manner of such valuation is articulated in explanation appended to Section 56(2)(viib). It requires comparison

[2] The Apex Court decision in the case of *CIT v Allahabad Bank Limited (1969) 73 ITR 745 (SC)* which held that share premium is includible in paid-up capital [although in the context of rebate in super-tax]. Share premium emerges only on issue of shares. It cannot be recognised before such issue.

Thus, in the context of Section 54GB, consideration received for issue of shares refers to a status prevailing on or after the issue of shares to the subscriber. The statute recognises that consideration for issue of shares occurs on or after the issue of shares.

between value prescribed under Rule 11UA of Income-tax Rules, 1962 and value substantiated by the assessee on the date of issue of shares. The higher of the two values constitutes FMV for the purposes of Section 56(2)(viib). Thus, income quantification requires value as on the date of issue of shares. The computation mechanism becomes unworkable if shares are unissued. Failure of computation mechanism defeats the charge of tax. No charge can be created under Section 56(2)(viib) until the shares are issued by the closely-held company.

(B) Guidance from Semantically Similar Provision

Section 54GB exempts capital gains from transfer of residential property if the sale consideration is invested in manufacturing small and medium enterprises ("MSME"). Sub-Section (1) therein provides the timeline within which net consideration on transfer of residential property should be invested in MSME. Clause (ii) to sub-Section (1) reads *the assessee, before the due date of furnishing of return of income under sub-section (1) of Section 139, utilises the net consideration for subscription in the equity shares of an eligible company (herein referred to as the company);…* Sub-Section (2) deals with consequences of non-utilisation of consideration in the manner laid out in sub-Section (1). The opening portion of sub-Section (2) reads- "The amount of the net consideration, which has been received by the company for issue of shares to the assessee, to the extent it is not utilised by the company for the purchase of the new asset before the due date of furnishing of the return of income..." Sub-Section (4) deals with consequences of transfer of shares. The opening portion reads *If the equity shares of the company or the new asset acquired by the company are sold….*

One can discern that sub-Section (1) deals with *consideration for subscription to shares*; sub-Section (2) refers to consideration for issue of shares; and sub-Section (4) states shares acquired by a company. In other words, consideration for issue of shares has been understood to mean payment received towards shares subscribed by the assessee or which is acquired by him. It refers to a point in time *on or after* acquisition of shares by the assessee. Thus, in the context of Section 54GB, consideration received for issue of shares refers to a status prevailing on or after the issue of shares to the subscriber. The statute recognises that consideration for issue of shares occurs on or after the issue of shares. The interpretation of the phrase *consideration for issue of shares* in the context of Section 54GB should be applicable to Section 56(2)(viib) as well. Accordingly, in the context of Section 56(2)(viib), consideration for issue of shares refers to a timeframe post issue/allotment of shares.

Corporate laws suggest that securities premium arises only on the issue of shares:

I. Section 56(2)(viib) deals with receipt of share premium. The term *share premium* or *securities premium* is not defined in the Act. The Guidance note on terms used in financial statements issued by ICAI defines *share premium* to mean the excess of share price over their face value. The Companies Act does not define *securities premium*, but the company law provisions detail with accounting and utilisation of such premium.
II. Section 52 of Companies Act, 2013[3] mandates a company issuing shares at a premium to transfer an amount equivalent to premium collected in a separate account called *Securities Premium Account*. The section heading reads *application of premiums received on issue of shares*. The statute recognises share premium 'on' issue of shares.
III. Prior to issue of shares, *securities/share premium* does not exist. Till issue of shares, the amount received by the company would amount to share application money or advance towards allotment of shares. Schedule III to Companies Act, 2013 indicates this treatment. It categorises application money to be one of the forms of *other current liabilities*.
IV. Share application money includes advance towards allotment of share capital. Share application monies could include premium but it continues to remain a part of the share application money. Such premium is not recognised as *securities premium* until the underlying securities/shares are issued. To explain, issue of prospectus is an invitation to offer. Applying for

[3] 78(1) of the Companies Act, 1956 was similarly worded

shares is an offer made by the applicant to the company. Allotment of shares is the acceptance of offer by the company. Once shares are allotted, the applicant becomes a shareholder. A share applicant can withdraw application before allotment. In such an eventuality, the company has to return the share application money. Accordingly, the amount paid towards premium at the time of share application money is carved out as securities premium only on allotment or issue of shares (when the offer of the applicant is accepted by the company).

V. Thus, unless shares are issued or allotted, recognition of share premium is not possible. Extending the same analogy, Section 56(2)(viib) is applicable only on or after *issue of shares*.

(C) Share Application Money is a Debt until Shares are Allotted

All monies received by a company towards share application have to be deposited in a separate bank account[4]. If the allotment is not made within the prescribed period, the said monies have to be refunded forthwith to the applicants. The Scheme of the Act itself obligates the company crediting the money as Share Application Money to either forthwith issue shares or refund the monies at the earliest[5].

The Bombay High Court in *Reserve Bank of India v Bank of Credit and Commerce International (Overseas) Ltd. [1993] 78 Comp. Cas. 230 at 235* held that the capacity in which the bank receives share application money is a fiduciary capacity and same cannot be used for purposes other than those specified.

Share application money is money received under trust. Until the allotment is made by the company, the relationship is one of debtor and creditor. Only on allotment, the amount received is transferred to share capital. A. Ramaiya has acknowledged this aspect in his *Guide to the Companies Act*[6]. The Bangalore ITAT in *ACIT v G.M.R. Industries Ltd. [ITA No. 814/H/2007]* held that share application money until allotment is a debt [although in the context of Section 36(1)(iii)].

Share application money is money received under trust. Until the allotment is made by the company, the relationship is one of debtor and creditor. Only on allotment, the amount received is transferred to share capital.

However, contrary view of the judiciary is also in evidence. The Delhi Tribunal in *Winner Estates (P) Ltd. v DCIT (2004) 91 ITD 431* held that share application money would become a debt only when shares could not be allotted requiring a return of cash. The Karnataka High Court in *Bangalore Soft Drinks (P) Limited (1980) 126 ITR 38 (Kar)* held that the share application money could not be considered as loan or borrowing. The amount had been paid for specific purpose and was returnable only if the shares were not allotted. One could argue that these decisions are distinguishable as they were not rendered in the context of Section 56(2)(viib). However, the larger issue appears to be the rationale of these judgments. The Karnataka High Court adjudged that share application money can be a *debt* when the non-allotment is confirmed. The question is what is the status of such receipts till then? Possibility of non-allotment always lingers at a share application stage [although the probability may be lesser in private placements *vis-à-vis* a public issue]. There is an inherent contingency of refund until the allotment is crystallised. To recognise share application money before the allotment as *income* would be against the *real income* theory of income recognition[7].

Thus, there are merits to contend that the year of taxability in case of Section 56(2)(viib) is the year of issue of shares which follows the receipt of monies towards such issue.

To conclude, Section 56(2)(viib) aims at arresting inflow of black money into the corporate finance. The pricing of equity shares should be commensurate with the actual worth. Fair valuation of equity shares is the underlying dictum. Unreasonable or artificial acceleration in share valuation has been sought to be taxed. This incremental valuation has been statutorily roped in as income. Although the objective is clear, the language employed does not clarify the point of taxation and, even though the *receipt* of consideration appears as cynosure, it should be accompanied with the issue of shares by a company. ■

[4] This is the mandate of Section 42 of Companies Act, 2013

[5] *Bhajan Singh Samra v Wimpy International Ltd. (2012) 111 SCL 1 (Del)*

[6] 'Debtor-creditor relationship on receipt of share application money in the context of Section 73 of Companies Act, 1956' [Guide to the Companies Act, 16th edition, Volume I, p.898]

[7] As per the real income theory, only those incomes which accrue or arise are taxable. Hypothetical incomes are outside the purview of income-tax. An income is the one that gives the owner a disposable capacity.