TAX FLASH NEWS

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Allotment of bonus shares cannot be considered as received for an inadequate consideration, and therefore, it is not taxable as income from other sources

Background

Recently, the Bangalore Bench of the Income Tax Appellate Tribunal (the Tribunal) in the case of Dr. Rajan Pai[1] (the taxpayer), held that when there is an issue of bonus shares, there is a detriment suffered by the recipient shareholder, through the depression in the value of the shares held by him/her. There is a consideration flowing out, which is exactly counterbalanced by the value of the bonus shares received. Accordingly, the bonus shares can never be considered as received without consideration or for inadequate consideration, and therefore, it is not taxable under Section 56(2)(vii)(c) of the Income-tax Act, 1961 (the Act) under the head 'Income from other sources.'

Facts of the case

- The taxpayer is an individual and had filed his return declaring certain income. During the assessment proceedings, the Assessing Officer (the AO) noted that the taxpayer had received 10 million equity shares from Manipal Education & Medical Group (India) P. Ltd (MEMG), as bonus shares against his holding of 5,000 fully paid-up equity shares in the said company. The face value of each share was INR10.
- The AO was of the opinion that the taxpayer, not having paid any consideration for the bonus shares, was obliged to offer the fair market value as 'Income from other sources'.
- The taxpayer took a stand that bonus shares were taxable only when the beneficiary received the shares and not on the allotment relying on the CBDT circular[2].
- According to the AO, the circular referred by the taxpayer was in relation to Section 115R of the Act, which dealt with bonus units issued by a mutual fund house. The AO applied Rule 11UA of the Income-tax Rules, 1962 (the Rules) and determined the fair market value of the bonus shares. The addition was made under Section 56(2)(vii)(c) of the Act under the head 'Income from other sources'.

The Tribunal's ruling

- The genesis for the introduction of Clause (v) to (vii) of Section 56(2) was apparently to curb the abuse arising out of abolishment of tax on a gift. By virtue of Clause (3) to Section 3 of Gift Tax Act, 1958 inserted by Finance (No.2) Act, 1998, the provisions of the Gift Tax Act ceased to apply to any gifts made after 1 October 1998. Before this, taxable gifts made by a person were charged at the rate of 30 per cent in the hands of the donor.
- Between October 1998 and August 2004, there existed a period of free for all, when neither the donor nor the donee had to pay tax on the gifts. To redress the situation, the Finance Act (No.2), 2004, inserted Clause (v) to Section 56(2) with effect from 1 April 2005, and Clause (xiii) to Section 2(24) of the Act, by virtue of which receipts without consideration or inadequate consideration were made taxable in the hands of the recipient taxpayer.
- Subsequently, Clause (vi) was introduced by the Taxation Laws (Amendment) Act, 2006 w.e.f. 1 April 2007, and Clause (vii) by the Finance (No.2) Act, 2009 w.e.f. 1 October 2009 were only the extrapolation of the above intention.

[1] DCIT v. Dr. Rajan Pai [ITA.1290/Bang/2015, (Assessment Year: 2012-13)]
[2] CBDT Circular No.6/2014, dated.11 February 2014

- Before the introduction of Clauses (v), (vi) and (vii), and during the period that the Gift Tax Act was applicable, the issue of bonus shares was never considered as a gift by a company to its shareholder and never subject to gift tax in the hands of the company considering it to be a donor.
- When the above clauses were introduced in Section 56(2), after the repeal of the Gift Tax Act, for redressing the vacuum created on account of such a repeal, the legislative intention was not to include therein items which were not within the ambit of Gift Tax Act.
- A perusal of Clause (c) of Section 56(2)(vii) of the Act, shows that two situations are considered therein. First is where a property is received without consideration, and second where it is received for a consideration less than the fair market value.
- The Tribunal, through an illustration, demonstrated that there is a prorate decrease in the value of equity shares when there is an issue of bonus shares. Thus, when there is an issue of bonus shares, there is a detrimental effect suffered by the recipient shareholder, through the depression in the value of the shares held by him/her. There is indeed a consideration flowing out which is exactly counter balanced by the value of the bonus shares received. The simple reason is that when bonus shares are issued by capitalising a portion of the reserves and surplus, there is no increase in the asset value of a company, in any manner.
- What happens is that the value of the equity shares goes down pro-rata. The total value of the equity shares held along with the bonus shares remains the same. Thus, any profit derived by the taxpayer on account of receipt of bonus shares is theoretically offset by the depression in the value of the equity shares already held by him/her.
- Bonus shares do not result in a recipient getting a property without consideration or for inadequate consideration. It is for this reason that the Mumbai Tribunal in the case of Sudhir Menon HUF[3] made the following observations:
  - ➢ The issue of bonus shares is by definition capitalisation of its profit by the issuing-company
  - ➢ There is neither any increase nor decrease in the wealth of the shareholder (or of the issuing company) on account of a bonus share issue, and his/her percentage holding therein remains constant
  - ➢ What in effect transpires is that a share gets split (in the same proportion for all shareholders), for example by a factor of two in a case of a 1:1 bonus issue[4]
  - ➢ There is no receipt of any property by the shareholder, and what stands received by him is the split shares out of his holding
  - ➢ It would be akin to somebody exchanging a one thousand rupee note for two five hundred or ten hundred rupee notes
  - ➢ Accordingly, there is no gift or accretion to property; the shareholder is getting only the value of his/her existing shares, which stands reduced to the same extent. The same has the effect of reducing the value per share, increasing its mobility and, thus, liquidity, in the sense that the shares become more accessible for transactions and thus, trading.
- The Supreme Court in the case of Dalmia Investment Co. Ltd had held that if the bonus shares ranked pari passu with the original shares, they had to be valued at the average of both the bonus and the original shares. It was held that bonus shares can never be given nil value, but it was also held that its value has to be worked out by the principle of averaging.
- The principle enunciated, in the above case, is that for every bonus share issued, there is a corresponding reduction in the actual fair market value of the equity share originally held. The taxpayer who received bonus shares could never be considered as receiving something without consideration or for a consideration less than the fair market value of the property.
- When bonus shares are received, it is not something, which has been received free or for a lesser fair market value. Consideration has flown out from the holder of the shares, may be unknown to him/her, which is reflected in the depression in the intrinsic value of the original shares held by him/her.

[3] Sudhir Menon HUF v. ACIT [2014] 148 ITD 260 (Mum)

[4] Reference in this regard may be made to the Supreme Court's decision in the case of Dalmia Investment Co. Ltd [CIT v. Dalmia Investment Co. Ltd. [1964] 52 ITR 567 (SC)], as well as in Khoday Distilleries Ltd. [Khoday Distilleries Ltd. v. CIT [2009] 176 TAXMAN 142 (SC)], wherein reference stands made to the former, also quoting therefrom, besides inter alia, to the case of Hunsur Plywood Works Ltd.[Hunsur Plywood Works Ltd. v. CIT [1998] 229 ITR 112 (SC)] where the same were referred to as 'capitalisation shares'.

- Thus, Section 56(2)(v), (vi) and (vii) brought into the Act the need for addressing the vacuum caused due to the withdrawal of the Gift Tax Act, which cannot be used for the purpose of taxing the value of bonus shares received by a taxpayer.
- The valuation of unquoted shares set out in Rule 11 UA(B) will be applicable only on the receipt of shares as a gift or for an inadequate consideration. Bonus shares can never be considered as received without consideration or for inadequate consideration calling for application of subclause (c) of Clause (vii) of Section 56(2) of the Act. Accordingly, the addition made by the AO is deleted.

Our comments

The Mumbai Tribunal in the case of Sudhir Menon HUF held that in the case of bonus shares, there is neither any increase nor decrease in the wealth of the shareholder, and therefore, the provisions of Section 56(2)(vii)(c) would not apply to bonus shares.

In line with the reasoning in the Sudhir Menon case, the Bangalore Tribunal in the present case held that when bonus shares are issued by capitalising a portion of the reserves and surplus, there is no increase in the asset value of a company, in any manner. Consequently, for every bonus share issued, there is a corresponding reduction in the actual fair market value of the equity share originally held. The taxpayer who receives bonus shares could never be considered as having received something without consideration or for a consideration less than the fair market value of the property. Accordingly, the fair market value of the bonus shares cannot be taxed as income from other sources.

The Tribunal observed that during the period when the Gift Tax Act was applicable, the issue of bonus shares was never subjected to gift tax in the hands of the company considering it to be a donor. When the clauses were introduced in Section 56(2), for redressing the vacuum created on account of the repeal of the Gift Tax Act, the legislative intention was not to include therein items which were not within the ambit of the Gift Tax Act. Accordingly, Section 56(2)(v), (vi) and (vii) of the Act cannot be used for the purpose of taxing the value of bonus shares received by a taxpayer.

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