

Should investors be subjected to "gift-tax" when subscribing to listed shares?

Key Takeaways

- Listed companies generally issue the shares at SEBI mandated floor price. However, allotment of shares due to procedural requirements can happen only after a month or more resulting in stock price run up and notional gains
- This run up in market price may inadvertently be caught under ambit of "gift tax", which seeks to tax the difference between consideration paid and fair value (market price) on the day of receipt of shares as deemed income of the shareholder
- Such taxation appears to contradict the legislative intent and prior guidance of the tax department for such scenarios
- Aligning valuation timelines and methods should help investors, who may otherwise bear the cost of lack of harmonisation of tax and SEBI regulations

Typically, income tax is levied on the actual income received by a person. To address situations where income is underreported, an anti-abuse provision, often referred to as "gift tax", is enforced. The presumption is that, in the ordinary course, people will not sell an asset for less than its fair market value.

The function of this anti-abuse provision – Section 56(2)(x) – is straightforward. If someone purchases an asset and as consideration pays an amount that is less than the "fair market value", then the difference between the fair market value and the consideration actually paid will be treated as income of the buyer, since it is deemed to be received without consideration.

Though the provision is well-intended to plug tax leakages, the broad language of this provision has certain consequences which seem to be at odds with its stated purpose and discernible rationale.

Preferential allotments: The gift tax overhang for listed shares

There may be some practical challenges when dealing with certain trades that involve listed shares/ securities – we discuss the case of preferential issues. There are two important parts to this:

a. ***Price*** – To protect the interest of public shareholders, SEBI has a regulated minimum price for a preferential issue of securities. This price is derived from the market value of the shares over a short period preceding the date when the investor first signs a share subscription agreement/ the board approves a preferential issue.

In effect, this ensures there is no undervaluation of the subscription price, and

b. ***Timeline*** – Unlike private companies, which can complete allotments within a day or so, listed companies can take around 45 days from date of signing the agreement with the investor.

Here's how the tax consequences of these play out

Many companies making preferential allotments see a run up in their stock price from the day the allotment is announced to the day the shares are allotted (which may take around 45 days).

This notional gain may trigger the gift tax provision since the fair market value[1] for listed shares, under the income tax law, is taken as the *lowest quoted share price on the valuation date* (which is the date when the shares are received by the investor).

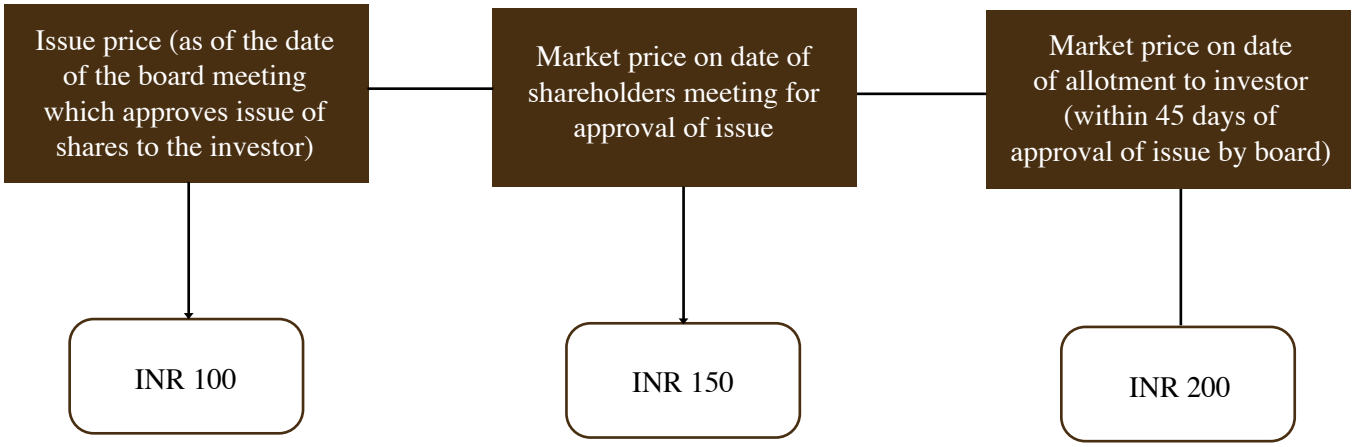
To delve into this, let's take an example:

[1] Determined by Rule 11UA of the Income Tax Rules, 1962.

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An investor signs a share subscription agreement with a ListCo to subscribe to its shares at a price of INR 100 per share. This is also the floor price (minimum price) computed as per SEBI regulations.

As soon as the details of the share subscription are announced, the price per share of the ListCo starts moving up. By the time shareholders vote on the special resolution approving the allotment, the price per share is INR 150. Once shareholders approve, the shares still have to be actually allotted, and at the time at which they are allotted, the market price of ListCo's shares has shot up to INR 200.



Tax Department's POV (notional gain may be taxed):

For reference, Section 56(2)(x) states that whenever a person "receives" any property (which includes shares and securities), for a consideration that is less than the fair market value of the property, the difference in that value and consideration shall be treated as taxable income.

If a literal interpretation of Section 56(2)(x) is followed, the investor in the above-mentioned scenario may be subject to tax on the difference between the allotment price and the fair market value on the date the shares are actually allotted (i.e., INR 100).

This interpretation of the term "receives" (which is necessary for tax to be levied under Section 56(2)(x), detailed further below) may also cover receipt by ways other than transfer, which should include receipt of shares (which in this case would be created).

Our view (no tax on notional gains):

There could be a view basis a technical reading, purposive interpretation and judicial precedents, that the notional gain in share price should not be held as income and taxed.

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a. The technical reading of the taxing incidence – Since the tax is predicated on what a "*person receives, … from any person*", it's possible to say that a fresh issue of shares is not a receipt but rather a mere creation of a right in the hands of the receiver. This reading is backed by judicial precedents which differentiate between "transfer" and "creation", with a preferential allotment not seen as transfer[2].

   In cases of ambiguity, courts have allowed for a more favourable reading to the assessee[3]. This ambiguity on what constitutes "receives" along with the stated legislative intent makes for plausible case for preferential issues to not be taxed under Section 56(2)(x). Of course, one could argue that the term "receives" could go beyond "transfer" (since different words have been used purposively) and that acquisition by other means should also qualify as "receives"[4].

b. The purposive interpretation – Since Section 56(2)(x) was brought in as an anti-abuse mechanism, its intent could not have been to tax *bona fide* transactions. This view is bolstered by the tax department's own prior application of the principle.

   On 31 December 2018, the Central Board of Direct Taxes ("**CBDT**") issued a circular ("**Circular 1**")[5], clarifying that Section 56(2)(viia) does not apply to fresh share issuances. This is relevant since Section 56(2)(viia) (which did not specifically mention preferential issues) was subsumed into Section 56(2)(x), which was introduced on April 01, 2017, to expand its application. The circular and the explanatory notes to the Finance Act, 2010 stated that Section 56(2)(viia) targets share transfers at low prices, not fresh share issuances. Thus, Circular 1 provided clarity and comfort to stakeholders by confirming that fresh issuances are not treated as share transfers in this context.

   However, the CBDT subsequently issued two more circulars on January 4, 2019 ("**Circular 2**")[6] and January 21, 2019 ("**Circular 3**")[7] withdrawing the position of Circular 1 citing that the matter relating to the interpretation of the term "receives" in Section 56(2)(viia) of the Income Tax Act is pending in higher judicial forums.

   High Courts have also ruled in favour of assessees on a fact-specific basis (for instance on bonus issuances) observing that there is no evidence pertaining to the assessee's intention to evade tax liability (under the prior iteration i.e., Section 56(2)(vii))[8]. Thus, on a purposive interpretation of Section 56(2)(x), a bona fide transaction such as a preferential issue of listed shares, done in compliance of SEBI regulations, should not be taxable under the gift tax provision.

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[2] Khoday Distilleries Ltd. vs. CIT: 307 ITR 312.
[3] See Mysore Minerals v. Comm. of Income Tax, Karnataka (1999) 7 SCC 106 and CIT v Vatika Township (2015) 1 SCC 1.
[4] Sudhir Menon HUF vs. ACIT: 148 ITD 260 (Mum.).
[5] Circular No.10/2018 dated 31 December 2018.
[6] Circular No. 2/2019 dated 4 January 2019.
[7] Circular No. 03/2019 dated 21 January 2019.
[8] PCIT v Ranjan, I.T.A. No. 501 OF 2016.

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Possible alternatives?

Interestingly, the Supreme Court, in a case on computation of gift tax under an earlier regime, held that when shares have restrictions on transferability, the prevailing price on the market cannot be taken and should instead be discounted to arrive at the actual value. This seems to have been employed even when the legislation in that case prohibited any such adjustments[9].

Since shares allotted by way of a preferential issue are locked in for at least 6 months (from the date of trading approval), investors should be, arguably, be permitted to discount the market price to account for the lack of transferability which may in turn compensate for any run up in prices.

Be that as it may, even if the shares were to be taxed, one should arguably consider the fair value (or the market value) on the date of the share subscription agreement when the assessee acquires the right to receive the property. The actual allotment is a mere procedure where the right to receive liquidates in exchange of the actual receipt of shares eventually.

Conclusion

The gift tax provision's consequences for preferential allotments seems to be more of an oversight by the tax department, and in the absence of clarity, has resulted in some costs for investors. A clear way to resolve such issues would be to take a holistic and integrated approach to the way valuation of shares is done, especially where other regulatory bodies are involved.

Pricing under SEBI regulations for listed companies is sufficient for the purposes of investment by overseas investors and there is no requirement for a further valuation report for compliance with FEMA. A similar approach can be taken here as well, with SEBI floor price being acceptable as a fair market valuation for income tax purposes. This also dovetails with news reports of the government's intent to align valuation standards across legislations.

[9] Deputy Commissioner Of Gift Tax, Central Circle-II v M/S BPL Limited, Civil Appeal No. 3265 & 3272 of 2016.

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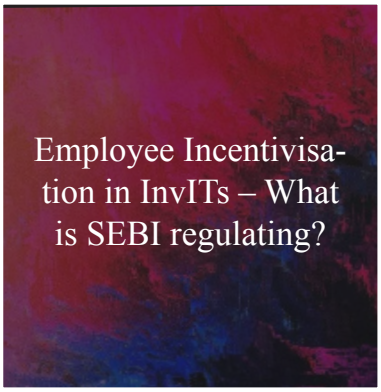
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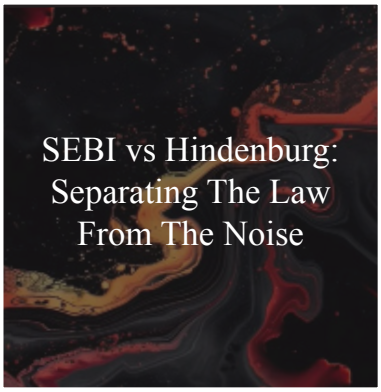
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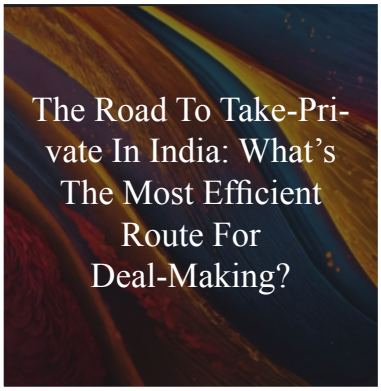
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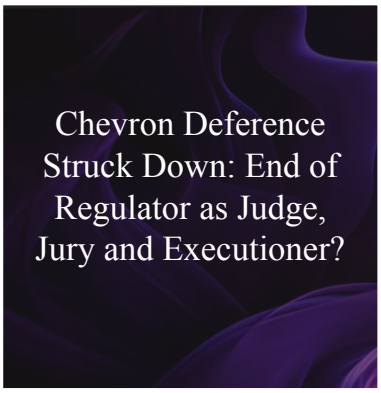




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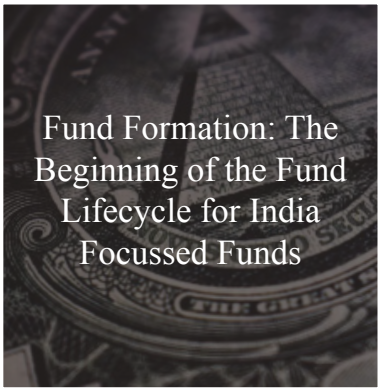






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