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Tax alert: Bombay HC holds proportionate rights allotment at less than FMV as not taxable

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The Bombay High Court (HC) has held that section 56(2)(x) of the Income-tax Act, 1961 (ITA) cannot be invoked merely to tax the difference between the subscription price and the FMV of the rights equity shares proportionately allotted to the taxpayer. The same was on the basis that on allotment the taxpayer's percentage shareholding remained unchanged and no disproportionate benefit was identified.

In a nutshell

Fresh shares come into existence upon allotment. An allotment is therefore distinct from the acquisition of an existing shareholder's shares, and a proportionate rights issue must be examined in the context of the shareholder's existing interest in the company.

Merely because the subscription price is lower than the prevailing average market price, it cannot automatically be inferred that the taxpayer received a corresponding economic benefit.

The issuance of additional shares also has a bearing upon the value of the existing shares. Therefore, the difference between the subscription price and the market price **cannot**, without examining the nature and effect of the rights issue, be regarded as income arising from the receipt of property for inadequate consideration.

Section 55(2)(via) of the ITA recognises the issuance of rights shares as distinct transactions for the purposes of determining their cost of acquisition. They must, therefore, be read harmoniously with section 56(2)(x) of the ITA. It does not mean that the provisions governing cost of acquisition, by themselves, create an exemption from section 56(2)(x). However, they reinforce the necessity of examining the true legal character of a rights allotment rather than mechanically treating every difference between the subscription price and the market price, as taxable income.

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Background:

- The taxpayer[1], an Indian company, subscribed to rights equity shares of another Indian company A Co at the price of say INR 12 per share.
- According to the Revenue, the difference between the subscription price of INR 12 per share and the fair market value (FMV) of say INR 15 per share determined as on the date of allotment, represented benefit received by the taxpayer. It sought to reassess the differential as income under section 56(2)(x) of the ITA [section 92(2)(m) of the Income-tax Act 2025] representing income which had escaped assessment.
- Aggrieved, the taxpayer filed writ petition against the reassessment proceedings before the Bombay High Court (HC).

Relevant provisions of the ITA

Section 56

"....
(2) In particular, and without prejudice to the generality of the provisions of sub-section (1), the following incomes, shall be chargeable to income-tax under the head "Income from other sources," namely:-

.....
(x)where any person receives, in any previous year, from any person or persons on or after the 1st day of April, 2017,-
(a) any sum of money, without consideration, the aggregate value of which exceeds fifty thousand rupees, the whole of the aggregate value of such sum;
(b) any immovable property,-
.....
(c) ***any property, other than immovable property,-***
(A) without consideration, the aggregate fair market value of which exceeds fifty thousand rupees, the whole of the aggregate fair market value of such property;
(B) for a consideration which is less than the aggregate fair market value of the property by an amount exceeding fifty thousand rupees, the aggregate fair market value of such property as exceeds such consideration .....:

Section 55

"....
(2) For the purposes of sections 48 and 49, "cost of acquisition", -
....
(aa) in a case where, by virtue of holding a capital asset, being a share or any other security, within the meaning of clause (h) of Section 2 of the Securities Contracts (Regulation) Act, 1956 (42 of 1956) (hereafter in this clause referred to as the financial asset), the assessee -
(A) becomes entitled to subscribe to any additional financial asset ; or
(B) is allotted any additional financial asset without any payment,

then, subject to the provisions of sub-clauses (i) and (ii) of clause (b),—
....
(iii) in relation to the financial asset, to which the assessee has subscribed on the basis of the said entitlement, means the amount actually paid by him for acquiring such asset......"

[1] Grasim Industries Ltd. vs. DCIT, Central [2026] 191 taxmann.com 663 (Bombay)

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Decision of the HC:

The HC acknowledged that the issue for consideration was, *inter-alia*, whether proportionate rights allotment gives rise to the receipt of a benefit of that character merely because the subscription price was below the FMV on the date of allotment.

- The question could not be answered by comparing the two prices alone. The legal nature and effect of allotment must be considered.

  Fresh shares come into existence upon allotment. An allotment is therefore distinct from the acquisition of an existing shareholder's shares, and a proportionate rights issue must be examined in the context of the shareholder's existing interest in the company.

- The taxpayer subscribed to rights equity shares of A Co at INR 12 per share. The issue was offered to the existing shareholders in proportion to their holdings, and the taxpayer's percentage shareholding remained unchanged after the allotment. The Revenue did not dispute this position.

  Instead, it contended that the difference between the FMV of INR 15 per share determined as on the date of allotment and the issue price, represented the benefit received by the taxpayer and the differential amount was brought to tax under section 56(2)(x) of the ITA.

- A reference to section 55(2)(aa) of the ITA [section 90 of the Income-tax Act, 2025] was also useful, which deals with the determination of the cost of acquisition of financial assets acquired pursuant to rights entitlements.

  - Clause (iii) thereof provides that, in relation to financial assets subscribed to on the basis of such entitlement, the cost of acquisition is the amount actually paid for acquiring the asset.
  - Clause (iiia) separately deals with assets allotted without payment.
  - Clause (iv) deals with assets acquired pursuant to the renunciation of rights.

  Further, a distinct rule has been provided for determining the cost of acquisition of property whose value has already been subjected to tax under Section 56(2)(x) of the ITA.

- The above provisions indicate that the ITA recognises the issuance of rights shares, the allotment of bonus shares and the acquisition of shares pursuant to renunciation of rights as distinct transactions for the purposes of determining their cost of acquisition. They must, therefore, be read harmoniously with section 56(2)(x) of the ITA.

  It did not mean that the provisions governing cost of acquisition, by themselves, created an exemption from section 56(2)(x) of the ITA. However, they reinforced the necessity of examining the true legal character of a rights allotment rather than mechanically treating every difference between the subscription price and the market price, as taxable income.

- The Supreme Court (SC) in an earlier ruling[2] whilst examining the nature of allotment of shares in the context of the Gift-tax Act, distinguished the creation of shares upon allotment from the transfer of shares already in existence. It held that an allotment represented the creation of shares by appropriation out of the unappropriated share capital of a company.

- The Gujarat HC[3], in another earlier ruling whilst examining the applicability of section 56(2)(vii)(c) of the ITA to rights shares allotted to an existing shareholder, held that shares issued pursuant to a rights issue come into existence only upon allotment and cannot be equated with pre-existing property received from another

[2] Khoday Distilleries Ltd. vs. CIT [2009] 176 Taxman 142 (SC)/[2008] 307 ITR 312 (SC)/[2008] 220 CTR 228 (SC)

[3] PCIT vs. Jigar Jashwantlal Shah [2023] 154 taxmann.com 568 (Gujarat)/[2024] 460 ITR 628 (Gujarat)

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person.

The HC further recognised that where shares were allotted proportionately to existing shareholders, the provisions concerning receipt of property for inadequate consideration would not operate in the manner suggested by the Revenue. Though the said ruling was on section 56(2)(vii)(c), the reasoning was relevant to the present case, considering the corresponding language relating to receipt of property employed in section 56(2)(x).

- Earlier ITAT rulings[4] also supported these facts. These decisions reinforced the need to examine what the shareholder actually received through the allotment. They did not warrant treating every subscription below market value as a taxable benefit.
- In the present case, merely because the subscription price was lower than the prevailing average market price, it could not automatically be inferred that the taxpayer received a corresponding economic benefit. The issuance of additional shares also had a bearing upon the value of the existing shares.

  Therefore, the difference between the subscription price and the market price **could not**, without examining the nature and effect of the rights issue, be regarded as income arising from the receipt of property for inadequate consideration.
- The Memorandum explaining the Finance Bill, 2010 described the relevant provisions as anti-abuse measures and explained the proposed extension to specified receipts of shares by firms and companies. The Memorandum explaining the Finance Bill, 2017 likewise described the existing provisions as anti-abuse provisions and proposed extending their scope through section 56(2)(x).

  These materials did not create a general exemption for every transaction described as commercial. They did, however, assist in construing the provision in its setting.

  This approach was consistent with earlier SC rulings[5] which stated that statutory language was to be read in its context and in the light of the object sought to be achieved, avoiding an unintended or absurd result where the language permitted a rational construction. These decisions did not authorise the Court to disregard a taxing provision. Instead, they supported examining the character and effect of the present rights allotment before concluding that the price difference represents the receipt of property for inadequate consideration.

The HC on the basis that in the allotment, in which the taxpayer's percentage shareholding remained unchanged, no disproportionate benefit was identified and the above discussion held that section 56(2)(x) of the ITA cannot be invoked merely to tax the difference between the subscription price and the FMV of the rights equity shares proportionately allotted to the taxpayer.

Comments:

Section 56(2)(x) of the ITA is an anti-abuse introduced for taxing receipt of specified property for inadequate or nil consideration. Its application often gives rise to interpretational issues concerning the determination of FMV, the identification of receipt of any real economic benefit, and the distinction between a transfer of an existing property and the creation of new property in context of a fresh issuance of shares. Amongst them, one of the issues is in the context of rights offerings, where shares may be allotted to existing shareholders in proportion to their shareholding. A debate exists whether the same would be covered by the operation of deeming fiction contained in section 56(2)(x) of the ITA.

[4] Sudhir Menon HUF vs. ACIT -21(2), Bendra Mumbai [2014] 45 taxmann.com 176 (Mumbai), ACIT, Cen. Cir. 8(2), Mumbai vs. Subhodh Menon [2019] 103 taxmann.com 15 (Mumbai)

[5] K.P. Varghese vs. ITO [1981] 7 Taxman 13 (SC)/[1981] 131 ITR 597 (SC)/[1981] 24 CTR 358 (SC), CIT v J.H. Gotla, 1985 AIR 1698 (SC)

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Further, a debate exists whether one needs to follow the literal language of provisions or consider the intent of the provisions as well.

The High Court in this ruling, while holding that a proportionate allotment of rights shares does not, by itself, give rise to taxable income under section 56(2)(x) of the ITA, has, *inter-alia*, upheld / held the following principles:

- Fresh shares come into existence upon allotment. An allotment is therefore distinct from the acquisition of an existing shareholder's shares, and a proportionate rights issue must be examined in the context of the shareholder's existing interest in the company.
- Merely because the subscription price is lower than the prevailing average market price, it cannot automatically be inferred that the taxpayer received a corresponding economic benefit.
- The issuance of additional shares also has a bearing upon the value of the existing shares. Therefore, the difference between the subscription price and the market price **cannot**, without examining the nature and effect of the rights issue, be regarded as income arising from the receipt of property for inadequate consideration.
- Section 55(2)(via) of the ITA recognises the issuance of rights shares as distinct transactions for the purposes of determining their cost of acquisition. They must, therefore, be read harmoniously with section 56(2)(x) of the ITA. It does not mean that the provisions governing cost of acquisition, by themselves, create an exemption from section 56(2)(x). However, they reinforce the necessity of examining the true legal character of a rights allotment rather than mechanically treating every difference between the subscription price and the market price, as taxable income.

It may be pertinent to note that HC also dealt with validity of the reassessment proceedings and held that the notice issued under section 148 did not satisfy the mandatory requirements of section 148A. The HC also held that the notice was not accompanied by the information suggesting that income chargeable to tax had escaped assessment. Mere mention of the amount alleged to have escaped assessment is insufficient. Although the consequential notice under section 148 was issued within the extended limitation period, its validity remained contingent upon compliance with the mandatory requirements of section 148A. Accordingly, the reassessment proceedings were held to be invalid and unsustainable.

Taxpayers may want to evaluate the impact of this ruling to the specific facts of their cases.

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