

Shares forfeiture – Tax Treatment

- CA. Ashish Goyal, Advocate
ashishgoyalg@yahoo.com

1.0 Introduction

1.1 Taxation of share forfeiture has been a matter of some debate between the assessee and the department. Following article discusses the tax treatment in the hands of applicant and in the hands of company.

2.0 Tax Treatment in hands of Company

2.1 Present position

When company forfeits the share application money/ call money, it is a capital receipt in the hands of Company. The definition of income u/s. 2(24) is wide enough but it does not cover such a receipt.

- (a) In *Asiatic Oxygen Ltd. (1994) 49 ITD 355 (Cal.)*, it was held that amount forfeited from shareholders for default of payment of call money was capital receipt. Further, amount received on re-issue of forfeited shares and credited to share premium account was also a capital receipt.
- (b) In one of the latest decisions, the assessee-company had issued partly convertible debentures against which it received application money. However, after the allotment, the assessee could not make the payments as per the terms of the issued debentures. The Mumbai Bench of ITAT in deptt. appeal in *Deepak Fertilizers & Petrochemicals Corpn. Ltd. v. Dy. CIT [2009] 116 ITD 372* held that the amounts forfeited due to non-payment of call money could not be charged to tax.
- (c) In yet another case, the Ahmedabad Bench of ITAT in *Dy. CIT v. Brijlaxmi Leasing & Finance Ltd. [2009] 118 ITD 546* held that the share application which had been forfeited as per the terms of the prospectus could not be treated as a receipt in the normal course of the business of the assessee, which was engaged in financing and leasing business.
- (d) The Mumbai Bench of ITAT in *Prism Cement Ltd. v. Jt. CIT [2006] 101 ITD 103* held that the amount received by the assessee in lieu of issuance of debentures which were forfeited later on account of non-payment of call money, would assume the character of a capital receipt. Section 41(1) is not attracted and same cannot be treated as deemed business income.
- (e) In an interesting decision by the Mumbai Bench in *Jaikishan Dadlani v. ITO [2005] 4 SOT 138*, it was held that there cannot be any dispute about the position that the share capital forfeiture receipts are in the nature of capital receipts.

The tribunal went to the extent that the share forfeiture account is also not available for distribution of dividend. Therefore, even if any amount is lent from such money to shareholders, same cannot be treated as deemed dividend u/s. 2(22)(e).

2.2 New Section 56(2)(viiia)

The new section 56(2)(viiia) introduced by the Finance Act, 2010 deals with transactions done on or after 01.06.2010. A misnomer has been spread that the new provision provides for taxation of share forfeiture in hands of company. In my view the same does not deal with share forfeiture. The new provision is aimed at preventing the practice of transferring unlisted shares at prices much below their fair market value. The tax applies only when the shares are given by any person to a firm or a closely held company. Therefore, even after the new provision, share forfeiture is a capital receipt in hands of company.

2.3 Proposal in Direct Taxes Code, 2010

In the proposed Direct Taxes Code, 2010, such forfeited sums may get taxed as income from other sources (residuary head). Clause (t) of section 58(2) is worded in a manner to rope in forfeited receipts even if they have capital character. It reads as below:

“(t) any amount accrued, or received, on account of the cessation, termination or forfeiture of any agreement entered by the person, if the amount is not included under the head ‘Income from business’.”

2.4 Department’s view

The department has in many cases doubted the authenticity of share application money as one of the forms of bringing one’s own unaccounted money into business u/s. 68. Similarly recently the department is also putting a scanner on the forfeiture of share application money as one of the forms of cash credit u/s. 68. In case assessee is unable to establish the ingredients of section 68 in respect to forfeiture of share application money, the department will be very well within its purview to cover the same u/s. 68. Courts have held that section 68 is wide enough to cover share application money. *CIT vs Sophia Finance (1994) 205 ITR 98 (Del.)(FB)*

3.0 Tax Treatment in hands of Shareholder

3.1 Where a person invests in shares of a company but he could not pay the call money, the amount is forfeited. A question which has arisen is whether the amount of forfeiture is an allowable loss under the head capital gains to the shareholder.

3.2 Loss on share forfeiture allowable to investor

(a) In DCIT vs BPL Sanyo Finance Ltd. (2009) 312 ITR 63 (Kar.): 223 CTR 461 it was held that loss on account of forfeiture of share application money because of failure by assessee to pay balance amount on allotment of shares, is allowable as a short-term capital loss. There was no merit in view that on forfeiture of shares, there was no transfer and as such question of capital loss did not arise. In fact, in case of forfeiture of share application money, there was extinguishment of rights in the shares.

(b) In *CIT vs Chand Ratan Bagri (2010) 230 CTR 258 (Delhi)*, it was held that forfeiture of convertible warrants amounts to a transfer within meaning of section 2(47) as there is extinguishment of rights. Loss on such forfeiture was allowable to shareholder.

3.3 Provision in Companies Act, 1956

It may be worthwhile to know that as per *Table-A* of the Companies Act, 1956, the applicant becomes the member of the company. It is only on his failing to pay the call in accordance with the provisions of regulations, that he ceases to be a member of the company. The decisions above have taken support of the provisions of the Companies Act, 1956. It has been held that as soon as allotment is made, the assessee acquired rights in such share even if call monies are unpaid. Subsequently, when the shares are forfeited, it results in a “transfer” u/s. 2(47).

3.4 Proposed Direct-tax code, 2010

The position in hands of shareholder shall remain the same even in the Direct-tax Code as the definition of “transfer” u/s. 314(267) includes extinguishment of right in the asset. The shareholder shall therefore be allowed deduction for loss under Capital Gains.

4.0 Conclusion

To conclude, I shall quote Lord Keynes who on the lighter side said “*Men will do the rational thing, but only after exploring all other alternatives.*” So I suggest that the taxpayers shall be honest in not adopting the illicit means of laundering their black money by share forfeiture. I also feel that the Department shall also accept the legal position, which has been correctly envisaged by the courts, in regard to share forfeiture.