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DELHI HIGH COURT HOLDS THAT RECEIPT OF AMALGAMATED COMPANY'S SHARES UNDER AMALGAMATION AGAINST SHARES HELD AS STOCK-IN-TRADE IS TAXABLE AS 'BUSINESS INCOME'

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The Delhi High Court (HC) in *CIT v. Nalwa Investment Ltd ITA 822, 853, 935, and 961 of 2005* has held that transfer of shares held as stock-in-trade, in the scheme of amalgamation constitutes a taxable event under the head 'profits and gains from business and profession'.

Background

Nalwa Investment Limited (Taxpayer) held shares of Jindal Ferro Alloy Ltd (JFAL). During the concerned year, JFAL amalgamated into Jindal Strips Ltd (JSL). Pursuant to this amalgamation, the Taxpayer received shares of JSL in lieu of shares in JFAL and claimed exemption from capital gains tax under section 47(vii) of the Income Tax Act, 1961 (IT Act).

The Assessing Officer (AO) taxed the difference between the market value of JSL shares and book value of the shares held in JFAL as business income on the ground that the Taxpayer was holding the shares of JFAL as stock-in-trade and not as capital assets. The action of the AO was upheld by the Commissioner of Income-tax (Appeals).

Upon further appeal, the Delhi Bench of the Income Tax Appellate Tribunal (Tribunal) held that no profit accrued to the Taxpayer when shares of the amalgamated company are received in lieu of shares of the amalgamating company and further the question about whether the shares were held as stock-in-trade or as capital asset, did not require adjudication as long as the amalgamated company's shares were not sold or otherwise transferred for consideration.

Question before the Court

The question of law before the HC was whether 'transfer' took place upon receipt of shares in the amalgamated company in lieu of shares in the amalgamating company.

Ruling

The HC rejected the Tribunal's view and held that the taxability of the transaction would depend on the classification of shares, as receipt of amalgamated company's shares in lieu of amalgamating company's shares held as 'stock-in-trade' would be taxable as business income. Accordingly, the HC remanded the matter back to the Tribunal to adjudicate on the factual dispute regarding classification of shares as 'stock-in-trade' or 'capital assets'. To arrive at the above conclusion, the HC analysed the income-tax

implications on receipt of shares of amalgamated company under a scheme of amalgamation for each such classification – which is discussed in detail below:

➤ *Shares of amalgamating company held as 'capital assets'*

- The Court observed that shares of the amalgamating company can be said to have been 'transferred' for capital gains tax purpose mainly for the following reasons:
 - While section 47 of the IT Act exempts certain transfers from taxability under the head 'capital gains' (including shares held by shareholder of amalgamating company), it nonetheless considers it to be 'transfer' as such. Therefore, even to take benefit of the specific exemption under section 47(vii), the extinguishment of amalgamating company's shares under an amalgamation, would have to be regarded as a 'transfer'.
 - The HC relied on the judgement of the Supreme Court (SC) in *Grace Collis and Ors [2001] 248 ITR 323* wherein it was held that extinguishment of rights in the capital asset, being shares of the amalgamating company, amounts to 'transfer' of such shares.
- Having said that, the Court noted that if the shares are considered to be held as capital asset, both the Taxpayer and the Income tax Authorities agreed that section 47(vii) of the IT Act would apply to the Taxpayer's facts, and accordingly, there would be no capital gain tax in the Taxpayer's hands.

➤ *Shares of amalgamating company held as 'stock-in-trade'*

- The HC noted that unlike section 47(vii) which operates for the purpose of capital gains, there is no express exemption when shares of amalgamated company received against amalgamating company's shares which are held as 'stock-in-trade'.
- Relying on the ratio laid down by the SC in *Orient Trading Co. Ltd (1997) 224 ITR 371 (which dealt with exchange of shares held as stock-in-trade)*, the HC held that receipt of shares of the amalgamated company in lieu of shares of amalgamating company, does not merely represent a notional accretion / notional profit which has not been realized by the Taxpayer. The HC held that the fair value of shares received would need to be considered as realised by the Taxpayer.
- The HC observed that when shares are held as stock-in-trade, the tax analysis is not restricted to the concept of 'transfer', but instead on whether there is income chargeable to tax under the head 'Profits and gain of business or profession'. Having said that, the HC also held that the concept of 'extinguishment/transfer' would not lose its relevance altogether because the nature of the asset is 'stock-in-trade'. This is because, pursuant to amalgamation, shares in amalgamating company can be said to be getting extinguished and replaced by amalgamated company's shares which would be valued entirely on different fundamentals.
- The HC also noted that under the Companies Act, the shareholders who dissent to the scheme of the amalgamation are given the option of receiving cash or equivalent as the price for the shares based on the exchange ratio. The process of amalgamation would apply equally from both legal and taxation viewpoint, irrespective of the status of the shareholder (ie whether

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the shareholder is a dissenting shareholder receiving 'cash' or an approving shareholder receiving shares of the amalgamated company).

Comments

The ruling holds significance for taxpayers who hold shares as stock-in-trade, especially as it alters the common notion that a tax-neutral amalgamation under section 2(1B) read with section 47(vii) of the IT Act is tax-neutral for all concerned parties. This also assumes significance in relation to shares held as stock-in-trade from the perspective of claiming deduction of entire interest on borrowings from dividend income. It should also be borne in mind that both, conversion of stock-in-trade into a capital asset and *vice versa* is taxable under the IT Act.

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