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Tax Flash News

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Receipt of shares upon amalgamation, in substitution of shares of amalgamating company held as stock-in-trade, results in taxable business profits

Executive summary

As per the provisions of the Income-tax Act, 1961 ('the Act'), transfer of shares held as capital asset pursuant to the scheme of amalgamation is not chargeable to capital gains tax at the stage of amalgamation and the gains are taxable in the hands of the shareholder at the time of subsequent transfer of the shares of the amalgamated company.

However, there is no express provision dealing with the taxation of transfer of shares held as stock-in-trade pursuant to the amalgamation. The issue arises whether or not such transfer is also tax neutral.

The Supreme Court in the case of *Nalwa Investments*[1] has held that where the shares of an amalgamating company, held as stock-in-trade, are substituted by shares of the amalgamated company pursuant to a scheme of amalgamation, and shares so received are freely tradeable and capable of definite valuation, the substitution gives rise to taxable business income.

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[1] *Nalwa Investment Limited* v. *CIT* (Civil Appeal No. 153 OF 2026 - Arising out of S.L.P. (C) No. 2190 of 2021)

Facts of the case[2]

The taxpayer, an Indian investment company, held shares in two operating Indian companies – ICo1 and ICo2. The shares were recorded as investments in the balance sheet of the taxpayer.

During the financial year 1996-97, ICo1 was amalgamated with ICo2 under a scheme of amalgamation sanctioned by the relevant High Courts and the shareholders of ICo1 received shares of ICo2 in lieu of shares of ICo1 held by them.

In its return of income, the taxpayer claimed exemption under section 47(vii) of the Act in respect of the receipt of ICo2 shares in lieu of ICo1 shares, treating the same to be capital assets. Section 47(vii) provides that any transfer of shares (being a capital asset) held in an amalgamating company by a shareholder, in consideration of the allotment of shares in the amalgamated company, under a scheme of amalgamation, is not regarded as a transfer for capital gains purposes, provided the amalgamated company is an Indian company.

However, the Revenue denied the tax exemption, alleging that ICo1 shares were held by the taxpayer as stock-in-trade and, accordingly, it brought to tax the value of ICo2 shares as business income under section 28 of the Act, computed with reference to their market value.

The High Court ruled in favour of the Revenue, observing that if ICo1 shares were held as stock-in-trade by the taxpayer, then, upon receiving the shares of the amalgamated company (i.e. ICo2) in lieu of those held in the amalgamating company (i.e. ICo1), the taxpayer had, in effect, realised the value of its trading assets, and the difference in the value of such shares would be taxable as business profit under section 28 of the Act. The High Court remanded the matter to the Tribunal for determination of the nature of the taxpayer's holdings in ICo1, i.e., whether such holdings constituted capital assets or stock-in-trade.

Aggrieved by the High Court's order, the taxpayer filed appeal before the Supreme Court.

The core issue before the Supreme Court was whether, when shares of the amalgamating company (i.e. ICo1), if held as stock-in-trade, were substituted by shares of the amalgamated company (i.e. ICo2), this substitution itself constituted a realisation giving rise to taxable business income or, does the taxability arise only upon subsequent sale of the substituted shares (ICo2 shares).

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[2] This note does not cover the issue relating to jurisdiction of the High Court as per section 260A to decide on a matter which was not framed as a substantial question of law.

Taxpayer's contentions

No taxable event arises at the stage of amalgamation. Income can be said to arise only upon the actual realisation or sale of the substituted shares, and not at the point of their allotment in the amalgamated company.

The definition of the term "transfer" under the Act[3] is relevant only for the purpose of computing capital gains and has no application to stock-in-trade. Only the exploitation or realisation of stock-in-trade gives rise to business income.

Receipt of shares of the amalgamated company in lieu of shares held in the amalgamating company, even when such shares are held as stock-in-trade, did not constitute a 'sale' or 'exchange' giving rise to taxable business income. On amalgamation, the amalgamating company and its shares cease to exist. As a result, there is no subsisting property capable of being exchanged, and accordingly, no taxable business income arises from such transaction.[4]

Even if the fair market value of the shares allotted in the amalgamated company on the date of allotment exceeds the book value of the shares in the amalgamating company, such appreciation is purely notional. Real income would arise only upon the actual sale of the allotted shares, and until such realisation, no business income accrues.

Wherever the legislature intends to tax notional or deemed income, it has enacted specific provisions (e.g., section 28(iv)[5], section 28(via)[6] or valuation rules). In the absence of any analogous deeming provision in respect of amalgamation, provisions relating to business profits[7] cannot be judicially expanded to cover hypothetical or unrealised gains.

Revenue's contentions

Business profits are chargeable irrespective of whether they arise by way of sale, exchange, or otherwise. Unlike section 45 (capital gains), which specifically require a transfer of a capital asset, section 28 (business profits) is agnostic to the manner in which income accrues – whether convertible into money or not.

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[3] Section 2(47)

[4] *Vania Silk Mills (P.) Ltd.* v. *CIT* [1991] 191 ITR 647 (SC); *CIT* v. *Motors & General Stores (P.) Ltd*. [1967] 66 ITR 692 (SC); *CIT* v. *Rasiklal Maneklal (HUF)* [1989] 177 ITR 198 (SC)

[5] Value of any benefit or perquisite arising from business, whether convertible into money or not; or in cash or in kind.

[6] Fair market value of inventory converted into a capital asset

[7] Section 28

The Revenue relied on *Orient Trading*[8] ruling, wherein the Supreme Court held that the exchange of securities by a share dealer amounted to realisation of stock-in-trade, resulting in taxable profits.

Upon amalgamation, the shares of the amalgamating company cease to exist, and their value stands realised either in cash (for dissenting shareholders) or in the form of shares of the amalgamated company (for approving shareholders). Such realisation, when resulting in profit, is taxable as business profits.

Income accrues when it becomes due and when there exists a corresponding liability on the other party. By virtue of the amalgamation scheme sanctioned by the court, there was a corresponding liability on the amalgamated company to issue shares in exchange for the extinguished shares of the amalgamating company, thereby, satisfying the test of real income.

A scheme of amalgamation itself has 'all the trappings of a sale', as held in *Hindustan Lever*[9]. Thus, the taxable event had occurred in the instant case.

Supreme Court's decision

The Supreme Court ruled in favour of the Revenue holding that the receipt of shares of the amalgamated company in substitution of stock-in-trade can give rise to taxable business profits. The Supreme Court held that the remand of the matter by the High Court to the Tribunal for factual determination, i.e. whether the shares were held only as investment or as stock-in-trade, was proper and justified and accordingly, directed the Tribunal for fresh adjudication in accordance with the law.

Key observations of the Supreme Court included:

Scope of section 28

Section 28 is a comprehensive charging provision which becomes applicable the moment any income arises out of business. The provision does not prescribe "transfer" as a precondition, unlike section 45 (capital gains).

Business profits may accrue or be realised in diverse circumstances, even without a conventional sale or exchange. To confine the operation of section 28 to such modes would unduly restrict a provision that the Parliament has intentionally couched in broad terms.

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[8] *Orient Trading Company Ltd*. v. *CIT* [1997] 224 ITR 371 (SC)

[9] *Hindustan Lever and another* v. *State of Maharashtra and another* [2004] 9 SCC 438

For the purposes of section 28, what is material is that there must be business profits which are ascertainable with reasonable definiteness at the relevant point of time, and the taxpayer must have either received it (or acquired a vested right to receive) and commercially realise it, even if the receipt is in kind.

Receipt or accrual of income upon amalgamation

In the context of amalgamation, the shareholder's interest in the amalgamating company is replaced by a corresponding interest in the amalgamated company. For the purposes of section 28, it is important to determine whether such substitution constitutes either a receipt or an accrual of income.

Receiving shares of the amalgamated company in lieu of shares held in the amalgamating company as trading stock, is a receipt of consideration in kind.

In the case of *Grace Collis*,[10] this Court has held that amalgamation, for the purposes of capital gains under section 45, does involve a "transfer" of shares. Even if this decision was rendered in the context of capital gains, that conclusion cannot be ignored while considering the ambit of section 28. Although amalgamation operates as a statutory substitution of rights, it may still give rise to taxable business profits.

The inquiry is not concluded by merely characterising the event as "transfer" in the legal sense – one must assess whether the substitution of shares yields real commercial profits arising in the course of business, so as to be chargeable as business profits.

Commercial realisability

Mere receipt of shares does not suffice to attract section 28; commercial realisability is also required when income is received in kind – the recipient of income must have control over the income received.

Receipt of an asset of definite money's worth in substitution for another may amount to commercial realisation attracting taxability as per section 28.[11]

Following three conditions need to be assessed for taxability as business profits:

(a) The old stock-in-trade has ceased to exist in the taxpayer's books;

(b) The shares received in the amalgamated company possess a definite and ascertainable value; and

(c) The taxpayer, immediately upon allotment, is in a position to dispose of such shares and realise money, i.e. the shares are readily available for realisation.

[10] *CIT* v. *Grace Collis and others* [2001] 248 ITR 323 (SC)

[11] Orient Trading (supra)

If the aforesaid conditions are satisfied, the substitution of shares upon amalgamation bears the character of a commercial realisation – so as to yield real income, and accordingly, the business profit may be taxed at the stage of substitution itself. Otherwise, the taxability arises only upon the eventual sale of the shares (for instance, there is a lock-in period, or the amalgamated company is a closely held company).

Unless the shareholder is, by virtue of the substitution, placed in possession of an asset which is freely tradable and of an ascertainable market value, the principle of real income bars taxation at the stage of amalgamation.

Profits must be capable of definite valuation, so that the real gain or loss stands crystallised.

Distinction between capital assets and business assets

While the Act expressly carves out an exemption in respect of certain transfers in the context of amalgamation,[12] but that exemption is confined to capital assets – no such exception is contemplated in the case of business assets.

Where a shareholder holds shares as an investment, the underlying object is to remain invested in the corporate venture, and a mere amalgamation ordinarily does not alter that position. By contrast, section 28, which governs business profits contains no such carve-out, since stock-in-trade represents circulating capital, held for conversion into money in the ordinary course of business.

The substitution of one trading asset by another, such as the receipt of shares in an amalgamated company in lieu of shares held as stock-in- trade in the amalgamating company, cannot be equated with a mere continuation of an investment. It represents a commercial realisation in kind, for the new shares are distinct assets with a definite and presently realisable market value.

If amalgamations involving trading stock were insulated from tax by judicial interpretation, it would open a ready avenue for tax evasion.

Timing of taxability

In the context of amalgamation, the taxability under section 28 will be attracted only upon the allotment of new shares by the amalgamated company, when the

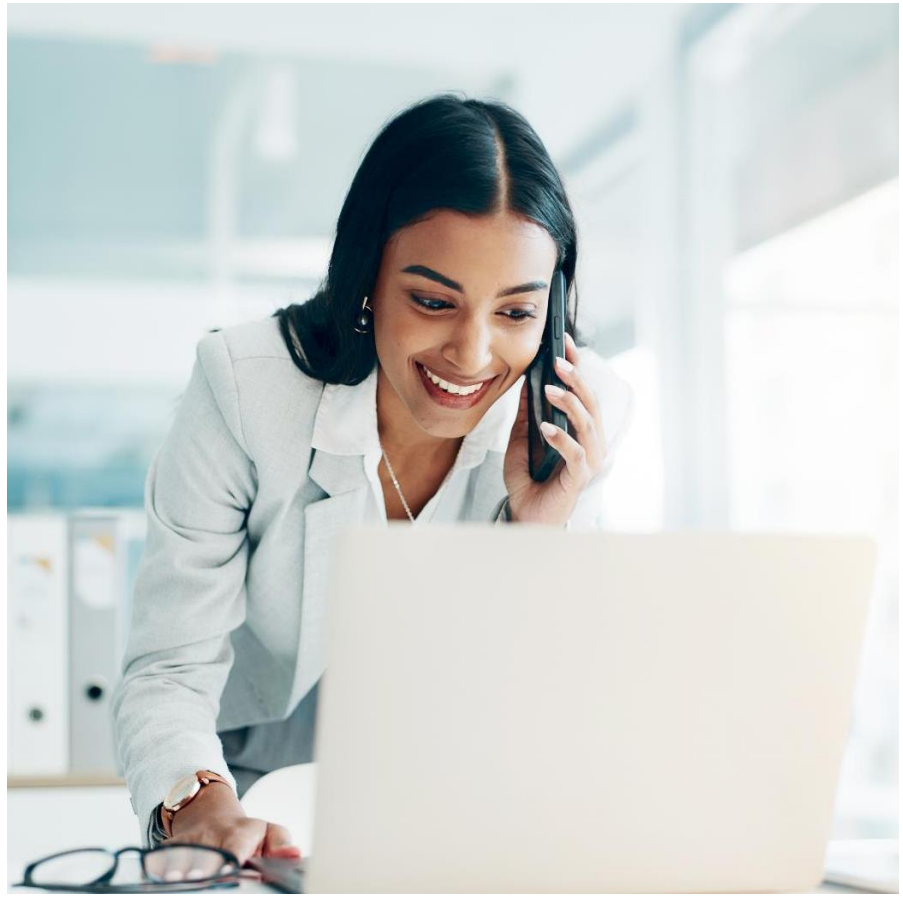
[12] Section 47

statutory substitution translates into a concrete, realisable commercial advantage. At the earlier stages namely, the appointed date or the date of court sanction, no such benefit accrues or is received.

Our comments

The Supreme Court ruling reinforces the need to distinguish between shares held as investments (capital assets) and those held as stock-in-trade (business assets), as the tax treatment upon amalgamation differs significantly.

The ruling also reaffirms that only real, presently realisable commercial gains—such as the receipt of freely tradable shares with definite market value—are taxable as business profits.



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