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Tax Flash News

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High Court ruling on the cost of asset received by a shareholder upon liquidation

Executive summary

In the case of liquidation of a company, the shareholder is required to pay capital gains tax on the fair market value (FMV) of the asset distributed less the cost of the shares held in the liquidating company. Once the aforesaid tax is assessed, the FMV of the asset is treated as the cost of acquisition (CoA) of the asset for the shareholder.

In the current case[1], the shareholder (taxpayer) received an asset as part of the liquidation proceeds and sold the same to a third party within the same financial year.

As the asset was sold within the same year as received by the shareholder, the capital gain arising on receipt of asset on liquidation as well as on sale of asset was computed and declared in the same tax return.

The tax authorities took a view that FMV of the asset on liquidation can be taken as cost only when the taxpayer has been assessed under the head "Capital gains" on the receipt of that asset. In this case since both the taxable events were in the same tax year, FMV of the asset at the time of liquidation can not be taken as cost for subsequent sale.

[1] *T.R. Balasubramanium* v. *ACIT* (TCA No. 438 of 2008). Source: Taxsutra

The High Court, however, upheld the taxpayer's approach, noting that applying the Revenue's interpretation would unfairly increase the taxpayer's tax burden.

Facts of the case

The taxpayer was a shareholder in a company that underwent voluntary liquidation. Upon liquidation, the shareholder received an immovable property in proportion to their shareholding.

Within the same financial year, the property was sold to a third party.

The issue in dispute was the determination of the CoA of the asset for the shareholder for computing capital gains arising from the sale.

The taxpayer offered capital gains on liquidation and on sale of assets in the same tax return.

However, the tax authorities disregarded the above treatment and taxed the sale of asset considering the cost of asset as cost to the previous owner i.e., the cost to the liquidated company on the ground that the taxpayer has not been assessed to capital gains tax upon receiving the asset from the liquidating company (under section 46 of the Income-tax Act, 1961).

The above treatments can be explained by way of an illustration:

	Taxpayer's approach	Revenue's approach
Gain on liquidation		
FMV of the asset on the date of distribution	150	
Less: Cost of shares	(100)	
Cap gains u/s 46 (A)	**50**	
Gain on sale		
Sale consideration	170	170
Less: Cost of the asset	(150)[2]	(80)[3]
Cap gains u/s 45 (B)	**20**	**90**
Total capital gains (A+B)	**70**	**90**

[2] *as per **section 55(2)(b)(iii)** FMV of the asset on the date of distribution is treated as the cost for the shareholder, provided it has been assessed to tax under the head "Capital gains" in respect of that asset under section 46*

[3] *applying **section 49(1)(iii)(c)** which deems the cost of asset received on liquidation to be the cost to the previous owner i.e., the liquidating company (assumed to be INR 80 for the illustration)*

Decision

The High Court ruled in favour of the taxpayer.

It emphasised that two separate transactions occurred:

Liquidation: transfer of shares i.e., extinguishment of rights therein.

Sale of asset: subsequent transfer by the shareholder of the assets received on liquidation.

The cost step-up is denied[4] when the taxpayer has not paid the tax arising on liquidation. However, in the current case the taxpayer did not defer tax liability but offered the gain to tax in the same year.

When both transactions occur in different years, tax under section 46 would be triggered in the year of liquidation, allowing the use of FMV as CoA for subsequent sale.

The tax liability should not change merely because both the transactions occurred in the same financial year

If the Revenue's interpretation is upheld, it would result in the taxpayer being burdened with a higher tax liability despite having done nothing wrong. In the instant case, the taxpayer has not delayed the tax liability arising at the liquidation stage but is instead reporting it for taxation in the same year the gains were realised.

Our comments

The ruling reinforces a pragmatic interpretation of tax provisions. This case affirms the principle that substance should prevail over form, especially when no tax deferral is involved.

[4] *applying* ***section 49(1)(iii)(c)***

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