KPMG

Tax Flash News

6 May 2023

The receipt of shares of a closely held company by a closely held amalgamated company pursuant to amalgamation for inadequate consideration is taxable as income from other sources under Section 56(2)(viia)

Executive Summary

If a closely held company receives shares of another closely held company from any person without consideration or for consideration which is less than the Fair Market Value (FMV) of the shares, such receipt of shares is taxable as income from other sources under Section 56(2)(viia) of the Income-tax Act, 1961 (the Act). Certain transactions relating to amalgamation/demerger/reorganization are specifically excluded from the applicability of Section 56(2)(viia).

The issue in the instant case was whether the receipt of shares of closely held companies by an amalgamated closely held company pursuant to amalgamation for inadequate consideration was taxable as income from other sources. The taxpayer contended that the shares received on account of amalgamation for inadequate consideration do not attract provisions of Section 56(2)(viia) as the transaction is not treated as a transfer/exempted from capital gains tax under Section 47(vi)[1]. Recently, the Hyderabad Bench of the Income-tax Appellate Tribunal (the Tribunal) in the case of Vertex Projects LLP[2] (the amalgamated company) held that the transaction of transfer of shares on amalgamation under Section 47(vi), though not regarded as a transfer for the capital gains tax, is not specifically excluded from the ambit of Section 56(2)(viia). Further, provisions of Section 56(2)(viia), being special provisions, would override the general provisions of Section 47(vi). Thus, such a transaction is taxable as income from other sources.

Facts of the case

- Pursuant to the scheme of amalgamation, the amalgamated company, which is an Indian entity, received assets of the amalgamating companies including quoted and unquoted shares, preference shares, etc. In consideration, the amalgamated company allotted equity shares to the shareholders of the amalgamating company.

- The Assessing Officer (AO) made an addition under Section 56(2)(viia) as the amalgamated company had not paid any fair market value of the assets received by it in the form of shares to the amalgamating companies.

- The Commissioner of Income-tax (Appeals) [CIT(A)] held that the shares received on account of amalgamation, for a price lower than the FMV of the shares, do not attract provisions of Section 56(2)(viia) as the transaction is not treated as a transfer/exempted from capital gains tax under Section 47(vi).

Tribunal's decision

- The proviso to Section 56(2)(viia) has provided an exception to its applicability and had only excluded such properties received by way of transaction not regarded as transfer which are mentioned in clause (via) or clause (vic) or clause (vicb) or clause (vid) or clause (vii) of Section 47. Thus, the transaction under Section 47(vi) will form part of Section 56(2)(viia), and therefore, the transfer/receive of shares of a closely held company will be chargeable as income from other sources in the hands of the recipient.

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[1] Transaction is not regarded as transfer for capital gains tax provisions on any transfer, in a scheme of amalgamation, of a capital asset by the amalgamating company to the amalgamated company if the amalgamated company is an Indian company

[2] ACIT v. Vertex Projects LLP (ITA No.1187/Hyd/2018) (AY 2014-15) - Taxsutra.com (The Tribunal, in this case, has dealt with several issues. However, only the issue with respect to the applicability of Section 56(2)(viia) to transactions covered under Section 47(vi) is covered under this flash news)

- Section 47(vi) provides an exemption of income arising on account of capital gain, on account of amalgamation of company, in the hands of the amalgamating companies, whereas transaction under Section 56(2)(viia) is chargeable in the hands of the recipient of shares i.e. amalgamated company if the consideration paid for 'receipt' of shares is below the FMV. The deemed income on account of receipt of any property being the shares of the company had been specifically included as 'income from other sources'.

- The law of interpretation of a statute is quite clear, which provides that if an income is chargeable under a specific provision, i.e., Section 56(2)(viia), then the general provision exempting such income, i.e., Section 47(vi) shall not be applicable.

- The bare reading of provisions of Section 56(2)(viia) makes it abundantly clear that the receipt of any property without or inadequate consideration or consideration less than the fair market value is the *sine qua non* for attracting this provision. The language used in the provision does not stipulate the transfer of shares. Further, the word 'receive' used in the provision includes the receive by way of transfer of shares also. In the instant case, the transaction of amalgamation satisfied these conditions and is therefore covered under Section 56(2)(viia)

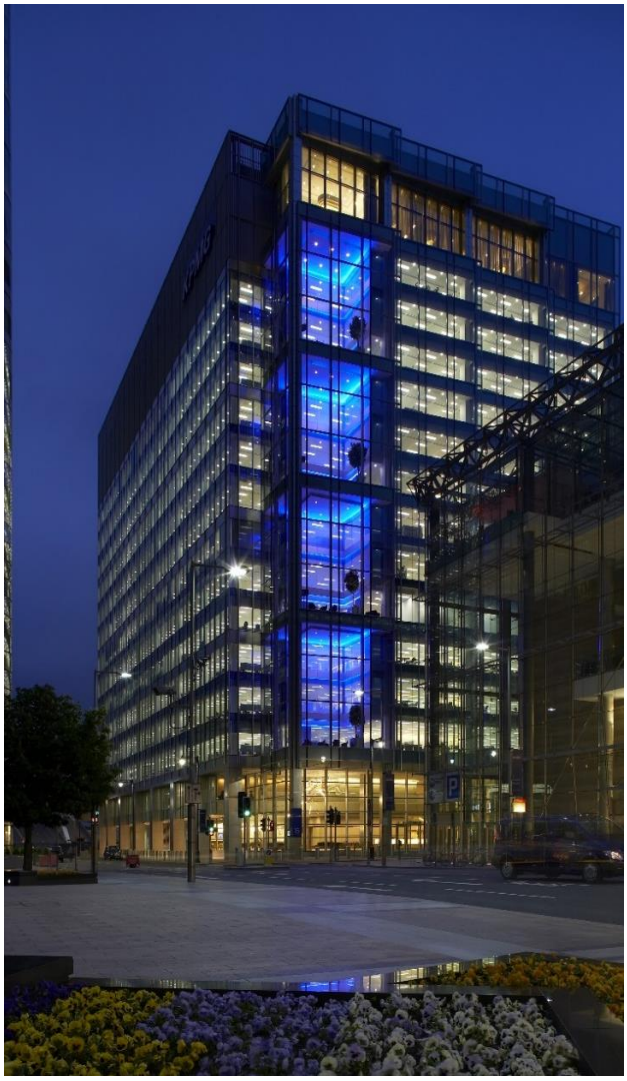
- Pursuant to the order of the High Court sanctioning the scheme, the assets were transferred and were deemed to be transferred to and vested in the amalgamated company. Undoubtedly, the transfer of shares had taken place, and therefore, the amalgamated company's contention was not correct that there was no transfer of shares. As mentioned in the scheme of amalgamation, the transfer of shares preceded the receipt of shares by the amalgamated company.

- The CIT(A) had misunderstood and misread the statutory provisions mentioned in Section 56(2)(viia) and wrongly concluded that the word 'receive' used in Section 56 only happens on account of transfer.

- Decisions[3] relied on by the amalgamated company were distinguished on the basis of the facts of the case.

Our comments

It is interesting to note that Section 56(2)(x) does not apply to transactions which are not regarded as transfer under Section 47(vi). Accordingly, the issue is relevant for merger transactions undertaken prior to 31 March 2017.



[3] Aamby Valley Ltd v. ACIT [2019] 102 taxmann.com 385 (Del), DCIT v. Ozone India Ltd [2021] 126 taxmann.com 192 (Ahm), Marshall Sons & Co. (India) Ltd. v. ITO [1996] 89 Taxman 619 (SC)

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