

M&A Tax Alert

August 18, 2020



Exchange of shares pursuant to an amalgamation amounts to 'taxable transfer' if such shares are held as 'stock-in-trade'.

The Delhi High Court in a recent ruling¹, set aside the order of the Tribunal on the aspect of taxability of shares received by the Taxpayer pursuant to amalgamation. The High Court also restored the matter back to Tribunal to examine whether the Taxpayer held the shares as 'stock-in-trade' or 'capital asset'.

Background

- The Taxpayer is part of Jindal Group of Companies and held shares in Jindal Ferro Alloy Ltd. ('JFAL' or 'Transferor Company'). Pursuant to a Scheme of Amalgamation ('Scheme'), JFAL merged with another group company, Jindal Strips Ltd. ('JSL' or 'Transferee Company') and as consideration for the merger, the Taxpayer received shares in the Transferee Company. The Taxpayer claimed an exemption under section 47(vii)² of the Income-tax Act, 1961 ('the Act').
- The Assessing Officer ('AO') contended that the Taxpayer held shares of JFAL as 'stock-in-trade' and hence was not eligible for exemption under section 47(vii) of the Act, which applies to capital asset. Accordingly, the difference between the market value of shares of JSL and the book value of shares of JFAL was charged to tax as profits by the AO, under the head profits and gains from business or profession.
- The CIT(A) upheld the order of the AO.

¹ The Commissioner of Income Tax-V, New Delhi v. M/s Nalwa Investment Ltd., ITA 822/2005 & connected matters.

² Per section 47(vii), transfer by a shareholder, in a scheme of amalgamation, of a capital asset being shares held by him in an amalgamating company is be regarded as an 'exempt transfer' subject to fulfilment of prescribed conditions.



- The Income-tax Appellate Tribunal ('Tribunal') held that no profit accrued to the Taxpayer unless the shares held by it are either sold or transferred otherwise for consideration, irrespective of the nature of holding.
- The Tribunal relied upon the decision of Supreme Court in case of *Rasiklal Maneklal*³ to arrive at the conclusion that no capital gains arise on receipt of shares pursuant to an amalgamation.
- The Revenue filed an appeal before the Delhi High Court against the order passed by the Tribunal.
- The moot question before the Delhi High Court was to determine whether a 'transfer' takes place upon receipt of shares of Transferee Company in lieu of the shares held in the Transferor Company.
- The High Court also deliberated on the taxability of the income/profit arising in case such shares are held as stock-in-trade.

Revenue's Contention

- The Tribunal in its ruling did not adjudicate upon a factual question as to whether the shares in Transferor Company were held as 'stock-in-trade' or 'capital asset'.
- The AO in his assessment treated the shares in the Transferor Company as 'stock-in-trade' and contended that the exemption under section 47(vii) of the Act had no relevance in the present case as the same applies to a capital asset.
- The Revenue relied on the Supreme Court decision in the case of *Grace Collis*⁴ wherein

it was held that upon an amalgamation, there is an extinguishment of rights in shares of the amalgamating company and such extinguishment of rights amounts to transfer. The Revenue also contended that the decision of *Rasiklal Maneklal* (supra) is based on the provisions of the erstwhile Income-tax Act, 1922 and such decision was duly considered in case of *Grace Collis* (supra).

- The Taxpayer earned profit by realizing the shares of JSL in exchange for JFAL shares. Reliance was placed on the Supreme Court decision in the case of *Orient Trading Co*⁵ wherein the taxpayer, a dealer in shares, held shares in a company as stock-in-trade and such shares were exchanged for shares of another company. The Supreme Court held that the difference between the book value of the shares of the first company and the market value of shares of the second company should be treated as profit earned by the taxpayer, by realising the value of shares.

Taxpayer's Contention

- The Taxpayer argued that there was no necessity for determining the nature and characteristic of the shareholding (whether the shares were to be considered as capital asset or stock-in-trade), since there is no income arising in the hands of the Taxpayer on mere receipt of shares of JSL.
- Even if the shares are treated as stock-in-trade, the receipt of shares in Transferee Company pursuant to amalgamation would amount to notional income and not realised profit from sale of stock-in-trade.

³ *Commissioner of Income-Tax, Bombay v. Rasiklal Maneklal (HUF)*, [1989] 177 ITR 198 (SC)

⁴ *Commissioner of Income-Tax v. Mrs. Grace Collis and Ors.*, [2001] 248 ITR 323 (SC)

⁵ *Orient Trading Co. Ltd. v. Commissioner of Income-Tax*, [1997] 224 ITR 371 (SC)



- Further, the Taxpayer relied on the decision of Rasiklal Maneklal (supra) and argued that it had not transferred any shares for a consideration and that the decision of Grace Collis (supra) had no relevance in the present case.

High Court Ruling

- The High Court in its ruling disregarded the reliance placed by the Tribunal on the ruling in the case of Rasiklal Maneklal (supra) as the said decision was based on definition of 'capital gains' as provided in the Income-tax Act, 1922. The erstwhile definition of capital gains included exchange and relinquishment but not a case of 'extinguishment of an asset/ rights in an asset'.
- The High Court also observed that the decision of Rasiklal Maneklal (supra) was considered by the Supreme Court in case of Grace Collis (supra) wherein the Supreme Court had referred to the expanded definition of transfer and had held that the shareholders' rights in shares of amalgamating company stand extinguished upon amalgamation of the amalgamating company and therefore, it constitutes transfer of shares in the amalgamating company. The argument undertaken in Grace Collis (supra) squarely applies to case in question as well. The High Court also noted that the concept of extinguishment or transfer remains the same irrespective of the classification of the shares as stock-in-trade or capital asset.
- Further, the High Court held that where shares were regarded as 'stock-in-trade', there would be realisation of income for the Taxpayer upon amalgamation since the shares of Transferor Company are replaced with the shares of the Transferee Company

and cannot be considered as same stock of inventory.

- In this regard, the High Court placed reliance on the decision of Supreme Court in case of Orient Trading Co (supra) and several other English cases dealing with receipt of shares upon amalgamation wherein the following observation was made:
 - Pursuant to amalgamation, the taxpayer was done with the investments in the transferor company and such investments had disappeared. Further, if there was an increase or decrease in value of shares post amalgamation, it would be that of the shares held in the transferee company, which are altogether different investments.
- The High Court also observed that the Tribunal's ruling lacked factual determination on the classification of shares and hence, the matter was remanded back to the Tribunal for fresh adjudication to settle the factual dispute relating to the nature of the holdings.

Dhruva Comments

- This decision of the High Court is an important one as it reiterates that the definition of 'transfer' as per the Act is a wide term and includes an extinguishment of capital asset or rights in capital asset, and where such shares are regarded as capital asset, the transfer would be eligible for an exemption under section 47(vii) of the Act.
- The decision also affirms the importance of classification of shares into investment or stock-in-trade. Accordingly, where the shares are considered as stock-in-trade, on amalgamation it would result in a 'transfer' and would be taxable under the head profits and gains from business or profession.



- While the CBDT allows a taxpayer to maintain two portfolios, one for investment and another for stock-in-trade, criteria laid down in circular no. 4/2007, dated June 15, 2007 and circular no. 6/2016 dated February 29, 2016 would act as a key reference to determine classification of the shares and the tax implications.
- The decision may act as a hurdle in case of merger of holding companies with operating company(ies), where it may be difficult to differentiate and substantiate whether shares in such operating companies are held as stock-in-trade or as investment.



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