Hyderabad Tribunal rules that receipt of shares in a scheme of amalgamation is taxable

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In a recent ruling, the Hyderabad Income Tax Appellate Tribunal (the "**Tribunal**") has, in the *Vertex Projects* case, held that if shares are received in a scheme of amalgamation by an amalgamated company being less than the fair market value ("**FMV**"), then the difference between the consideration received and the FMV will be considered as "income from other sources" and taxable in the hands of the recipient.

Background

Vertex Projects (the "**Taxpayer**") is a company engaged in the investment business, and pursuant to a scheme of amalgamation approved by the Andhra Pradesh High Court, eleven (11) amalgamating companies merged with the Taxpayer with effect from April 1, 2011. The amalgamating companies had identical shareholders, and post-amalgamation, their shareholding in the amalgamated company continued to remain the same. On this understanding, no fair market valuation reports were obtained to determine the swap ratio (which was 1:1) for the amalgamation.

The income tax officer (the "**ITO**") held that as the shares held by the amalgamating companies had been transferred to the amalgamated company for a consideration less than FMV, the difference between the consideration received and the FMV must be taxed under Section 56(2)(viia) of the Income-tax Act, 1961 (the "**IT Act**"). Under Section 56(2)(viia) of the IT Act, if a private company receives shares of another private company for a consideration less than the aggregate FMV of the shares by an amount exceeding INR50,000, the amount by which the aggregate FMV of such shares exceeds the actual consideration paid, is to be taxed as income from other sources.

In appeal, the Commissioner of Income Tax overruled the ITO's decision on the reasoning that under Section 47(vi) of the IT Act, any transfer in a scheme of amalgamation of a capital asset by the amalgamating company to the amalgamated company is not regarded as a "transfer," and capital gains tax will not apply if the amalgamated company is an Indian company (which was the case here). Therefore, this case did not come under the purview of Section 56(2)(viia) of the IT Act. Aggrieved, the ITO approached the Tribunal.

The Tribunal ruling

(i) Section 56(2)(viia) of the IT Act does not state that a transfer is required; the only requirement is "receipt of a property" (shares, in this case) without any or for consideration less than the FMV.

(ii) Section 47(vi) of the IT Act is an exemption from capital gains tax in the hands of amalgamating companies, whereas Section 56(2)(viia) of the IT Act makes chargeable to tax in the hands of a recipient of shares, consideration paid for "receipt" of shares below

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the FMV.

(iii) The proviso to Section 56(2)(viia) of the IT Act excludes only those transfers that are mentioned in Section 47 of the IT Act, namely, clause (via) that relates to amalgamation of foreign companies; clause (vic) that relates to demergers of foreign companies; clause (vicb) that relates to business reorganizations in co-operative banks; clause (vid) relating to transfer of shares by shareholders in a demerger; or clause (vii) relating to transfer by a shareholder in a scheme of amalgamation. Therefore, the intention of the legislature was not to exclude Section 47(vi) from the applicability of Section 56(2)(viia) of the IT Act, notwithstanding that a transfer of shares between Indian companies in a scheme of amalgamation is not regarded as a "transfer" at all.

(iv) Section 56(2)(viia) of the IT Act is a specific charging provision effective from June 1, 2010 and has an overriding effect over Section 47(vi) of the IT Act. The law of interpretation of tax statutes is that if an income is chargeable under a specific provision then the general provision exempting such income does not apply.

Our comments

Section 56(2)(viia) of the IT Act was intended to be an anti-abuse provision with no intention to tax a transaction not otherwise taxable under the IT Act. The Explanatory Memorandum to the Finance Act, 2010, provides that Section 56(2)(viia) excludes transactions undertaken for business re-organizations, amalgamations, etc. The newly introduced Section 56(2)(x) effective from April 1, 2017 subsumes Section 56(2)(viia) and has wider scope. The transaction of amalgamation covered under sub-clause (vi) of Section 47 has been specifically excluded from the purview of Section 56(2)(x) of the Act. This means that the intention of the legislature was never to cover a business re-organization (such as a tax-neutral amalgamation) within its scope.

There will likely be a further appeal to the High Court from the Tribunal's order. Notwithstanding this, we recommend that companies pursuing an amalgamation must obtain valuation reports even in case of intra-group mergers where the ultimate group shareholding remains unchanged after the amalgamation. This may serve to prevent unnecessary litigation.

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