AURTUS
CONSULTING

Direct Tax Alert

19 April 2021

Ahmedabad bench of Tribunal[1] holds that the excess of net assets taken over by the amalgamated company against issue of its shares at face value towards consideration for amalgamation cannot be taxed under section 56(2)(viib) of the Act.

Background

- Pursuant to a scheme of amalgamation approved by the High Court of Gujarat, assets and liabilities of an amalgamating company ('transferor company') were taken over by the taxpayer company ('transferee company' or 'amalgamated company').

- The shareholders of the transferor company were issued equity shares of the taxpayer company at face value as consideration in lieu of shares of the transferor company held by them. As a result, shares of taxpayer company of INR 15 crores in aggregate at face value were issued to the shareholders of the transferor company. The value of net assets (assets less liabilities) vested in the taxpayer company under the scheme was INR 54.21 crores. The difference between the share capital issued and the value of net assets received pursuant to merger (viz. INR 39.21 crores i.e. INR 54.21 crores less INR 15 crores) was recorded by the taxpayer company as Capital Reserve.

- The Assessing Officer ('AO') computed the total fair market value ('FMV') of shares issued on amalgamation at INR 6.81 per share as per Rule 11UA of the Income-tax Rules, 1962 as against the face value of INR 10 per share. Accordingly, the total FMV of shares issued on amalgamation was worked out to INR 10.21 crores.

- The AO added the excess of net assets taken over by the taxpayer company against the fair market value of shares issued i.e. INR 44 crores (INR 54.21 crores less INR 10.21 Crores) as the income of the taxpayer company taxable under section 56(2)(viib) of the Income-tax Act, 1961 ('the Act').

- On appeal before the first appellate authority, viz., the Commissioner of Income-tax (Appeals), the matter was held in favour

[1] *In the case of DCIT v. Ozone India Limited, I.T.A. No. 2081/Ahd/2018*

of the taxpayer company and the addition of INR 44 crores made under section 56(2)(viib) of the Act was deleted. It was held that the deeming provisions of section 56(2)(viib) of the Act cannot be invoked in the present case.

- The Revenue appealed against the order of the first appellate authority before the Ahmedabad bench of the Income Tax Appellate Tribunal ('the Tribunal').

Issue for consideration before the Tribunal

- Whether the deeming provisions of section 56(2)(viib) of the Act are applicable in a situation where shares are issued by the transferee company as consideration for vesting of assets and liabilities of the transferor company pursuant to a scheme of amalgamation?

Revenue's contentions before the Tribunal

- The AO contended that the aggregate consideration in the form of net assets received by the assessee company for issue of its shares which exceeds the FMV of such shares issued, is liable to be taxed as per the provisions of section 56(2)(viib) of the Act.

- It was contended that the taxpayer company clearly benefitted by the scheme of amalgamation and received excess consideration by way of net assets against issue of its shares to the shareholders of the transferor company.

- Such benefit received by the taxpayer company by way of excess consideration in kind is susceptible to taxation under section 56(2)(viib) of the Act.

Taxpayer's contentions before the Tribunal

- It was argued that the excess value of net assets vested on amalgamation cannot be notionally termed as premium over the face value for the purpose of deeming provisions of section 56(2)(viib) of the Act.
- Notional capital reserve account, by no stretch of imagination can be called as a share premium account or consideration for issue of shares.

- By virtue of amalgamation, the consideration is to be discharged by the taxpayer company by way of issue of its shares and it is not the case where consideration is being received by the taxpayer company from subscribers of shares which, if in excess of the FMV of the shares is liable to tax under section 56(2)(viib) of the Act.

Key observations of the Tribunal

The intent of the legislature appears to impose tax on deemed income only in case of issue of shares at premium. Provisions of section 56(2)(viib) are not applicable when shares are issued at face value.

- On a plain reading, following two aspects of the provisions of section 56(2)(viib) of the Act emerge:
  - Consideration which exceeds the face value of shares issued is subject to tax; and
  - In the event of shares issued at consideration above face value, the same needs to be compared with the prescribed FMV to arrive at the income to be taxed.

- Provisions of section 56(2)(viib) of the Act read in tandem with the Finance Minister's speech in Parliament disclosing the intent of introduction of these provisions, the Memorandum explaining the Finance Bill provisions and the supplementary memorandum explaining the amendments to Finance Act 2012 (CBDT Circular No. 3/2012 dated 12 June 2012) suggest that the

intention of the legislature is to tax hefty or excessive share premium received unjustifiably by private companies on issue of shares without having underlying value to support such huge premium and thereby enriching itself without paying any taxes. The subscription to the shares issued by a company at a substantial premium (not necessarily backed by a valuation justifying the premium) was supposedly resorted to convert unaccounted money.

A deeming provision has to be construed strictly

- Section 56(2)(viib) of the Act creates a deeming fiction to imagine and fictionally convert a capital receipt into revenue income. Relying on the Apex Court's decision in the case of *CIT v. Mother India Refrigeration Private Limited (1985) 155 ITR 711*, the Tribunal held that a deeming fiction cannot be stretched beyond its purpose and import another fiction in it.

- In the light of the object and purpose of the deeming clause, as discussed above, the provisions of section 56(2)(viib) of the Act would not be triggered where the taxpayer company has not charged any premium at all and the shares were issued at face value.

Provisions of section 56(2)(viib) of the Act should apply only in case of bilateral arrangements and not in case of issue of shares pursuant to a scheme of amalgamation which involves a tripartite arrangement between the transferor company, the transferee company and the shareholders of the transferor company

- The provisions of section 56(2)(viib) of the Act contemplate 'receipt' of consideration for the shares from a resident person. In other words, it contemplates a bilateral transaction between a resident person and the company issuing shares.

- However, in the case of an amalgamation, the consideration being the undertaking along with all its assets and liabilities is given by the transferor company, whereas the shares are issued to its shareholders. Thus, in effect, it is a tripartite arrangement between (i) transferee company (ii) transferor company and (iii) the shareholders of the transferor company. Such tripartite arrangements are not contemplated in the deeming provisions of section 56(2)(viib) of the Act.

The shares issued by amalgamated company is towards discharge of its consideration under a scheme of amalgamation

- In the present case, the issue of shares is to give effect to the scheme of amalgamation sanctioned by the Court.
- The issue of shares does not trigger any consideration but conversely, the obligation to give consideration to the shareholders of the transferor company triggers the issue of shares.

- The provisions of section 56(2)(viib) contemplate issue of shares by a company on its own and not to fulfil any obligation, viz. pursuant to amalgamation.

Exception to the provisions of section 56(2)(viib) of the Act for venture capital undertaking (VCU) supports the contention that provisions of section 56(2)(viib) should apply only in case of bilateral arrangements

- The Tribunal referred to the proviso to section 56(2)(viib) of the Act which exempts venture capital undertaking (VCU) from applicability of the provisions of section 56(2)(viib) of the Act on receipt of consideration from venture capital company / venture capital fund.

- If a view is adopted that the deeming provisions of section 56(2)(viib) of the Act

also apply to corporate restructurings, then in case of an amalgamation between two VCUs, the consideration in the form of net assets shall be considered to be received from the transferor VCU and not the venture capital company / venture capital fund. Therefore, the exemption granted under the proviso would become inapplicable although the shareholders of the VCUs could include venture capital companies / venture capital funds / non-residents / notified persons.

- Such a situation contradicts the intent of the legislature to exempt VCUs. Hence, in terms of the proviso, the provisions of section 56(2)(viib) of the Act cannot apply to a corporate restructuring such as amalgamation.

Exemption to shareholders under section 47 for receipt of shares of the transferee company in lieu of shares of the transferor company pursuant to amalgamation supports the contention of non-applicability of section 56(2)(viib) on amalgamation

- The Legislature contemplates that in case of an amalgamation, there is a 'transfer' of shares by the shareholders of the transferor company in consideration for issue of shares of the transferee company. Consequently, with a view to grant tax neutrality to the amalgamation, the Act provides suitable exclusion for such transaction from the ambit of expression 'transfer' under section 47(vii) of the Act which is also a deeming provision.

- Thus, as per the provisions of the Act, the consideration for issue of shares by the transferee company, in so far as the shareholder is concerned, is the shares held in the transferor company by way of transfer. Accordingly, a bare issue of shares contemplated under section 56(2)(viib) of the Act cannot be equated with a situation of transfer of shares gathered from an intent implicit under the provisions of section 47(vii) of the Act.

Aurtus Comments

- The deeming provisions of section 56(2)(viib) of the Act seek to tax premium received by a closely held company from residents on issue of shares, to the extent that the consideration received for such shares exceeds the FMV of the shares computed in accordance with specified rules.

- The Tribunal ruling tests the applicability of the deeming provisions of section 56(2)(viib) of the Act in the context of issue of shares pursuant to a corporate restructuring. This is a favourable ruling for the taxpayers which holds that when shares are issued by the transferee company pursuant to amalgamation at face value, the provisions of section 56(2)(viib) of the Act cannot be triggered irrespective of whether the net assets vested in the transferee company exceed the FMV of the shares issued.

- The Tribunal ruling reiterates the position that the deeming fictions, such as the provisions of section 56(2)(viib) of the Act, are applicable only for a definite purpose for which they are legislated and cannot be extended to situations beyond their legitimate field by importing another fiction in it. The ruling gives due weightage to the intent behind introduction of section 56(2)(viib) of the Act regarding taxing excessive share premium received without justification as laid down in the speech of the Finance minister and the Memorandum explaining the provisions of the Finance Bill.

- Reliance on this ruling can also be placed by taxpayer companies which have issued shares at premium pursuant to corporate restructuring to defend applicability of the deeming provisions of section 56(2)(viib) of the Act since the ruling holds that such

provisions are not applicable in situations involving tripartite arrangements between transferor company, transferee company and shareholders of transferor company.

- It will be interesting to see how the observations of the Tribunal are dealt with by higher judicial forums. Furthermore, the applicability of General Anti-Avoidance Rules ('GAAR') in case of shares issued in the course of a corporate restructuring without adequate justification also needs to be examined.

Mumbai
Wework, Raheja Platinum,
Sag Baug Road,
Off Andheri- kurla Road,
Marol, Andheri East
Mumbai - 400059

Gurugram
Wework, 5th Floor,
DLF Two Horizon Centre,
DLF Phase 5,
Gurugram,
Haryana - 122002

Ahmedabad
Paragraph - B- 601, Mondeal Heights,
Near Novotel hotel,
Sarkhej - Gandhinagar Highway
Ahmedabad -380015

Email : connect@aurtusconsulting.com