Tax Hotline

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DELHI HC HOLDS EXCHANGE OF SHARES HELD AS STOCK-IN-TRADE TO BE TAXABLE AS BUSINESS INCOME

- **Delhi High Court holds an exchange of shares in case of amalgamation constitutes 'transfer'.**
- **If such shares are not capital assets eligible for exemption under section 47(vii), the 'transfer' should instead be taxed under the head 'profits and gains from business and profession'.**
- **Ignores the principle that heads of income are mutually exclusive.**

In a recent decision,[1] the Delhi High Court held that an exchange of shares that are held as stock-in-trade in case of an amalgamation should be taxable under the head 'profits and gains from business and profession'.

FACTS

Nalwa Investment Limited ("**Nalwa / Taxpayer**"), promoter of the Jindal Group of Companies, held shares of Jindal Ferro Alloy Ltd. ("**JFAL**"). During the year under consideration, JFAL got amalgamated into Jindal Strips Ltd. ("**JSL**") – ("**Amalgamation**"). As part of the Amalgamation, Nalwa transferred its shares in JFAL in lieu of receipt of shares of JSL and claimed that the Amalgamation was exempt from capital gains tax per the exemption under section 47(vii) of the Indian Income Tax Act, 1961 ("**ITA**").

The assessing officer ("**AO**") held that the difference between the market value of the shares of JSL and book value of the shares held in JFAL was taxable as business income. It noted that the since Nalwa was holding JFAL shares as stock-in-trade and not as capital assets, it was not entitled to the exemption under section 47(vii) of the ITA.

Upon appeal, the conclusion of the AO was upheld by the Commissioner of Income Tax (Appeals) ("**CIT (A)**").

Interestingly, upon further appeal, the Income Tax Appellate Tribunal ("**Tribunal**"), without getting into the question of stock-in-trade v. capital assets, held that no profit accrues when shares of the amalgamated company are received in lieu of shares of the amalgamating company. Specifically, it noted that *"no profit accrues unless the shares held by an assessee are either sold or transferred otherwise for consideration irrespective of the nature of holding".*

When the matter reached the Delhi High Court, the fundamental question which had to be considered was whether receipt of shares in the amalgamated company in lieu of shares in the amalgamating company constitutes a 'transfer'.

ARGUMENTS

Consideration	Taxpayers' Arguments	Revenue's Arguments
Question of stock-in trade v capital assets.	Irrespective of whether the shares were held as stock-in-trade or capital assets, there is no taxable income which arose in the hands of the Taxpayer.	The fundamental question predicating the taxability is whether the shares constituted stock-in -trade or capital assets.
Whether exchange of shares constitutes 'transfer'.	Only profit realized on actual sale / transfer could have been subject to tax. In the present case, following the Supreme Court ruling in *CIT v. Rasiklal Maneklal*[2], the exchange of shares did not result in a transfer. The crucial point borrowed from *Rasiklal Maneklal* was that receipt of shares of the amalgamated company in lieu of shares of the amalgamating company is considered to be done automatically by operation of law (transmission) and does not involve active transfer in exchange for shares in kind. Accordingly, such exchange of shares as part of an amalgamation does not constitute a 'transfer'. On the Revenue's reliance on *Orient Trading,* the Taxpayer argued that it was not applicable in the present scenario. The said case involved realization of profit arising out of accretion in value of shares received in exchange – which is	The exchange of shares constitutes 'transfer'. The reliance on *Rasiklal Maneklal* is erroneous. The said case where exchange of shares in case of an amalgamation was held to not be a transfer was only relevant in the context of the Income Tax Act of 1922, where the provision for capital gains did not include 'extinguishment of shares'. Reliance should instead be placed on the subsequent Supreme Court ruling in *CIT v. Grace Collis*[3] where taking into account the definition of transfer under section 2(47) of the ITA (which included extinguishment of shares within its ambit) – it was held that exchange of shares in case of an Amalgamation constituted 'extinguishment of shares' and hence fell within the ambit of 'transfer'. Reliance must be placed on the Supreme Court's decision in *Orient Trading Co. Ltd. v. CIT*[4]. In this

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	different from the scenario where there was been a mere exchange (by operation of law) and no accretion in value of shares.	case, the shares held as stock-in-trade were transferred in lieu of shares in the transferee entity. The court held that surrendering of shares in the first company in lieu of shares in the transferee company constituted 'transfer' and the profits realized so were to be taxed as business income.
Real v. Hypothetical Income	Only real (and not notional / hypothetical) income is to be considered for the purposes of taxation under the ITA. No real income arose on receipt of shares in JSL in lieu of shares in JFAL and hence, there was no taxable income that arose out of the Amalgamation.	
Capital Gains	Without prejudice to the above submissions, even if the shares were held as 'capital assets' exemption from capital gains tax under section 47(vii) would be available.	Although a transfer, since the shares were held as stock-in-trade (by the taxpayers' own submission), provisions of section 45 and section 47(vii) could not be invoked. Reliance in this regard was placed on the Supreme Court ruling of *G. Venkataswami Naidu Co v. CIT*[5].

RULING

- Transfers exempt from tax under section 47 of the ITA, nevertheless are a 'transfer' to begin with. Thus, if the Taxpayer were to contend that the shares in question were held as 'capital assets' in order to take benefit of the exemption, the receipt of shares in the amalgamated company would have to be regarded as a transfer.
- The receipt of shares in JSL in exchange for shares of JFAL constituted a 'transfer'. The ratio under *Rasiklal Maneklal* dealt with applicability of capital gains provisions of the 1922 Act which did not include 'extinguishment of shares' as transfer and hence was not applicable in the present scenario. Instead the ratio of *Grace Collis* is applicable – where it was held that even when exchange is happening by operation of law – it should constitute transfer on the basis that such exchange results in 'extinguishment of shares' which forms a part of the definition of 'transfer' under section 2(47) of the ITA.
- In case a 'transfer' is not taxable by virtue of section 47(vii), its taxability would be governed by section 28 of the ITA. Accordingly, income arising out of 'transfer' of stock-in-trade should be chargeable to tax under the head 'profits and gains from business and profession'.
- On the point of hypothetical income raised by the Taxpayer, while appreciation in value of shares while remaining in the hands of the same person should not constitute real income, receipt of shares of a higher value in exchange for shares of a lower value should constitute real income. In the present case, it was the latter and hence, the 'exchange' resulted in actual profits accruing to the Taxpayer.

ANALYSIS

This is an interesting judgment where there appears to be a thin line separating arguments of both sides. However, it seems that the Delhi High Court may not have taken into account some basic aspects while rendering this ruling.

Simply speaking, the crux of the Taxpayer's argument is that the exchange of shares, being stock-in-trade, could not be taxed as it did not result in the creation of any profits. Such profits arise only upon sale / transfer of shares, which was not the case in the present Amalgamation.

Importantly (and it is unclear from the text of the decision whether this argument was pressed by the Taxpayer), when it is being considered whether an event constitutes a 'transfer' for the purposes of determining taxability under the head 'profits and gains from business and profession', the normal meaning of 'transfer' and not the one under section 2(47) for the purposes of capital gains taxation should be taken into account. This follows from the text of section 2(47) that begins with the words "*"transfer", in relation to a capital asset …*". In assessing the meaning of 'transfer' under section 2(47), the Court seems to have brought the transaction within the ambit of provisions governing taxation of income under the head 'capital gains' (which in themselves constitute a distinct code), and then opted to tax it under the head 'profits and gains from business and profession'.

Further, if a transaction is in fact considered a 'transfer' under section 2(47) and if it is not taxable under the head capital gains, the matter ends there, and tax authorities cannot then seek to tax it under another head. This follows from the general principle (confirmed by the Supreme Court in *Nalinikant Ambalal Mody v. SAL Narayan Row, CIT*[6]) that heads of income are mutually exclusive – i.e. if the receipts can be brought under a particular head of income and are not taxable by operation of the provisions for that head, it cannot be brought to tax under another head.

In addition, the judgment opens up certain consequential questions. For instance, what happens to the tax neutrality of the transfer of assets by the amalgamating company? Considering that many businesses would have a mix of capital assets and stock -in-trade, would the tax neutrality of an amalgamation be limited only to the extent of the shares constituting capital assets? Furthermore, what is the basis for valuation of shares for computing gains for the purposes of taxing under the head 'profits and gains from business and profession'? In the absence of any prescribed valuation mechanism, is it justifiable to use the fair market value, especially if the sanctioned scheme for amalgamation itself provides for the assets to be transferred at cost? These questions remain unanswered, and may come up for consideration in different fact patterns in light of the Delhi High Court's recent decision.

– Varsha Bhattacharya & Afaan Arshad
You can direct your queries or comments to the authors

[1] *CIT v. Nalwa Investment Ltd., ITA 822, 853, 935, and 961 of 2005*
[2] [1989] 177 ITR 198 (SC)
[3] [2001] 248 ITR 323 (SC)
[4] (1997) 224 ITR 371 (SC)

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[5] (1959) 34 ITR 594
[6] [1966] 61 ITR 428 (SC)

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