TT Alert

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Issue of shares at face value to the Shareholders of the Amalgamating Company pursuant to a Scheme of Amalgamation to not attract rigours of Section 56(2)(viib) of the ITA

The Hon'ble Ahmedabad ITAT in its recent ruling[1] has held that issuance of shares at face value by the Amalgamated Company to the shareholders of the Amalgamating Company, representing the consideration for net assets (i.e. excess of assets over liabilities) vested pursuant to a Scheme of Amalgamation will not trigger any implications under Section 56(2)(viib) of the ITA.

The Hon'ble ITAT while concluding the aforesaid had given due consideration to the facts of the case that the Amalgamated Company had not recorded any premium in its books on issuance of shares and the net impact of the merger i.e. difference between net assets and value of shares issued on merger was recorded as 'Capital Reserve' in the books of the Amalgamated Company.

Additionally, the Hon'ble ITAT had also observed that intention behind introduction of Section 56(2)(viib) of the ITA was to tax unaccounted money which is channelized through share infusion at high premiums (not backed by sustainable valuation) in closely held companies and does not cover cases wherein shares are issued at face value and no premium is charged on such issuance.

Background

Pursuant to the Scheme of Amalgamation, a closely held company ('hereinafter referred to as Amalgamating Company) was amalgamated with the Assessee Company ('Amalgamated Company'/ Assessee') wherein all the assets and liabilities of the Amalgamating Company were vested in the Amalgamated Company at book value except land parcels which were revalued and recorded as 'trading assets' in the books of the Assessee Company.

The Assessee had issued shares at face value to the shareholders of the amalgamating company in consideration of such vesting of assets and liabilities as per the Scheme of Amalgamation duly approved by the Hon'ble High Court of Gujarat with an appointed date of 1- Apr-2012.

The merger was accounted in the books of the Amalgamated Company in accordance with 'pooling of interest method' as prescribed by Accounting Standard 14 issued by the Institute of Chartered Accountants of India ('ICAI') consequent to which the difference between net asset of Amalgamating Company which were taken over at book value and the value of shares issued at face value was accounted as capital reserve in the books of Amalgamating Company.

During the course of tax assessment, the Assessing Officer ('AO') observed that the value of net assets as recorded in the books of the Assessee was more than the value (i.e. face value) at which shares were issued in lieu of such vesting of assets. The AO further observed that intrinsic value of shares issued by the Amalgamated Company was even less than the face value at which such shares were issued.

In light of the above, the difference between the value of shares issued (computed basis the intrinsic value of shares determined by the AO) and the value of net assets received on merger was added to the taxable income of the assessee as 'deemed income' under Section 56(2)(viib) of the ITA.

[1] *DCIT v. Ozone India Ltd.; (2021) 126 taxmann.com 192 (Ahd ITAT)*

Aggrieved by the order of the AO and the addition made, the assessee filed an appeal before the Commissioner of the Income-tax Appeals ('CIT(A)') who ruled in favour of the Assessee resulting in deletion of the addition and held as under:

- The differential (i.e. excess of value of shares issued over the net assets vested) recorded as 'Capital Reserve' and which is the subject matter of the addition under Section 56(2)(viib) of the ITA primarily was on account of revaluation of land which was recorded as a 'trading asset' in the books of the Assessee;
- The net impact of the merger in accordance with applicable Accounting Standards recorded as 'Capital Reserve' in the books of the Assessee by no means can be characterized as consideration for issuance of shares or as 'Share Premium' for the purpose of bringing the same under the garb of Section 56(2)(viib) of the ITA.

Aggrieved by the order of the CIT(A), the AO contested the deletion by contesting the matter before the Hon'ble ITAT who held as under:

What ITAT Held

The Hon'ble ITAT after giving due consideration to the facts of the case held as under:

- In an amalgamation, the issuance of shares is undertaken to give effect to the Scheme of Amalgamation ('Scheme') which is approved by the Jurisdictional High Court and thus such issuance of shares does not represent any consideration to the shareholders but an obligation on part of the Amalgamated Company which arises pursuant to the Scheme.
- Section 56(2)(viib) of the ITA contemplates issuance and receipt of shares between a resident shareholder and an issuing company i.e. a bilateral transaction and does not contemplate an arrangement like a merger which involves issuance of shares pursuant to a tripartite arrangement between an amalgamated company, amalgamating company and its shareholders
- In order to further stress on the non- applicability of Section 56(2)(viib) and its non- compatibility with current Scheme of the ITA governing taxation of mergers, the Hon'ble ITAT highlighted that consideration for issuance of shares by the amalgamated company as far as the shareholders are concerned is the shares held by them in the amalgamating company which though treated as a 'transfer' is exempt under Section 47(vii) of the ITA. Thus issuance of shares envisaged by Section 56(2)(viib) of the ITA cannot be equated with an event of 'transfer' which is explicitly exempt under the ITA.
- Additionally, the Memorandum to the Finance Bill, 2012 explaining the rationale behind introduction of Section 56(2)(viib) has clearly laid down that the objective behind insertion of the said Section was to tax unaccounted money which was infused in the Companies in the garb of high share premium without any sustainable valuation.
- The Hon'ble ITAT basis facts of the case distinguished that issuance of shares at face value by the amalgamated company to the shareholders of the amalgamating company pursuant to a Scheme of Amalgamation duly approved by the Jurisdictional High Court cannot be equated with transactions which Section 56(2)(viib) of the ITA intends to cover.
- Thus, in wake of the above, the addition made by the tax authorities under Section 56(2)(viib) of the ITA stands deleted.

Cases Relied by the Revenue

Chain Rup Sampatram v. CIT [224 ITR 481]

CIT v. Hind Construction Ltd. [83 ITR 211]

CIT v. Birla Gwalior Pvt. Ltd. [89 ITR 266]

CIT, Bombay City 1 v. Shoorji Vallabhdas & Co. 46 ITR 144

CIT v. M.CT.M Corporation Pvt. Ltd. [221 ITR 524]

CIT v. Leena Sarabhai [221 ITR 520]

Makers Development Services Pvt. Ltd. v. Dy. CIT [40 ITD 185]

CIT v. Mother India Refrigeration (P.) Ltd. [1985] 155 ITR 711

RBSA Take

Applicability of Section 56(2)(viib) of the ITA has been a contentious issue since its introduction in the ITA and more so in cases involving mergers and demergers in absence of any exemptions under the ITA, unlike Section 56(2)(x) of the ITA which carves out specific exemptions for tax neutral mergers and demergers.

The Hon'ble ITAT has taken a pragmatic approach while examining the applicability of Section 56(2)(viib) in the present facts of the case after giving due considerations to the nature of the transaction and the fact that no share premium was recorded pursuant to issuance of shares on merger by the Amalgamated Company.

Additionally, the Hon'ble ITAT has also recognized the intention behind introduction of Section 56(2)(viib) of the ITA vide the Finance Act, 2012, wherein the said section was introduced as an anti-abuse provision to deter the flow and use of unaccounted money which is introduced as share premium.

The ITAT has righty held that issuance of shares at face value pursuant to a merger cannot be brought under the ambit of Section 56(2)(viib) of the ITA considering that shares were issued by the Amalgamated Company for a non-cash consideration and does not results in any flow of money into the Company.

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