Tax alert: FMV of asset distributed to shareholders on liquidation, to be cost of acquisition

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The Madras High Court (HC) has held that, based on facts, the fair market value (FMV) of the asset on the date of distribution to shareholders pursuant to liquidation should be taken as the cost of acquisition while computing capital gains on transfer of such asset.

In a nutshell

Both section 49(1)(iii)(c) and section 55(2)(b)(iii) of the ITA provide for the COA of an asset which becomes the property of the taxpayer on the distribution of assets by a company on its liquidation. However, the applicability, of either of the provisions would depend on the situation in each case.

If the taxpayer had been charged to capital gains tax on receipt of the property under section 46, then, as per section 55(2)(b)(iii), the COA would be the FMV of the asset on the date of distribution. If the taxpayer had not offered the capital gains for taxation in the year of accrual, then the COA would be as per section 49(1)(iii)(c) i.e., cost to previous owner.

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Background:

- The taxpayer(s)[1] are shareholders in an Indian company (Company). During the Financial Year (FY) 1990-91 corresponding to Assessment Year (AY) 1991-92, the Company went into voluntary liquidation.
- On liquidation, the immovable property belonging to the Company was valued, and the value thereof was distributed to the taxpayers in proportion to their shareholding. Subsequently, in the same year the taxpayers sold their share of the property.
- In the return of income, the taxpayers declared capital gains considering the cost of acquisition (COA) under section 55(2)(b)(iii) of the Income-tax Act, 1961 (ITA).

  As per the section 55(2)(b)(iii) of the ITA, for the purposes of sections 48 and 49, cost of acquisition in relation to certain capital asset, "where the capital asset became the property of the assessee on the distribution of the capital assets of a company on its liquidation and the assessee has been assessed to income-tax under the head "Capital gains" in respect of that asset under section 46, means the fair market value of the asset on the date of distribution".
- During the course of reassessment proceedings, the Assessing Officer (AO) computed the COA in terms of section 49(1)(iii)(c) of the ITA (relating to cost with reference to certain modes of acquisition).

  As per section 49(1)(iii)(c) of the ITA, "Where the capital asset became the property of the assessee...

  ...(iii) (c) on any distribution of assets on the liquidation of a company,...

  ...the cost of acquisition of the asset shall be deemed to be the cost for which the previous owner of the property acquired it, as increased by the cost of any improvement of the assets incurred or borne by the previous owner or the assessee, as the case may be."
- Aggrieved, the taxpayer filed an appeal and in the course of appellate proceedings, the matter reached before the Madras High Court (HC).

  The contention of the taxpayer was that section 55(2)(b)(iii) of the ITA overrides the provisions of section 49(1)(iii)(c) of the ITA as the taxpayer had acquired the shares of the company prior to liquidation. Hence, section 55(2)(b)(iii) should be adopted as a mode of computing the COA as against section 49(1)(iii)(c) of the ITA.

Relevant provisions in brief:

Relevant extract of Section 46 of the ITA

"(1) Notwithstanding anything contained in section 45, where the assets of a company are distributed to its shareholders on its liquidation, such distribution shall not be regarded as a transfer by the company for the purposes of section 45.

(2) Where a shareholder on the liquidation of a company receives any money or other assets from the company, he shall be chargeable to income-tax under the head "Capital gains", in respect of the money so received or the market value of the other assets on the date of distribution, as reduced by the amount assessed as dividend within the meaning of sub-clause (c) of clause (22) of section 2 and the sum so arrived at shall be deemed to be the full value of the consideration for the purposes of section 48."

Decision of the HC:

The HC noted that the sole legal issue that arose related to the computation of cost of acquisition under the provisions of the ITA of an asset distributed on liquidation of the Company. In this regard, the ITAT noted

[1] T. R. Balasubramanium v. Asst Commissioner of Income Tax [T.C.(A) Nos. 438 of 2008] (Madras HC)

/observed the following:

- In the case under consideration, both section 49(1)(iii)(c) and section 55(2)(b)(iii) were attracted as the transfer of shares, firstly, by way of extinguishment right therein and in consideration of which the taxpayer received the asset from the Company (transaction A) and secondly, by transfer of the asset received on liquidation and in consideration of which the taxpayer received actual money (transaction B).

  Both the transactions took place in the same FY as the taxpayers proceeded to sell their share of the property in the same FY where the asset had been distributed to them, fusing the applications of both applicable statutory provisions.

- In this regard, the ITAT in case of one of the taxpayers in the case under consideration, had made the following observations:
  - Section 46(2) of the ITA provides that when a shareholder receives money or any other asset from a company on its liquidation, then such shareholder shall be charged to capital gains tax. This capital gain is on account of transfer of shares effected by extinguishment of rights in the shares.

    The section further provides that sales consideration for the purpose of computing capital gains will be money actually received or fair market value of the asset on the date of distribution, as the case maybe. The said sales consideration would be as reduced by the amount assessed under section 2(22)(c) of the ITA (relating to deemed dividend).

    In the case under consideration, there was no such amount assessed and therefore, for the sake of brevity, reference to fair market value FMV of the asset on the date of distribution would be presumed to be after such reduction and no further reference would be made to section 2(22)(c) of the ITA.
  - The transactions could be explained in arithmetical form by way of an example:

Particulars	INR
COA of shares by the taxpayer	100
FMV of the property received	150
Sales consideration of the property sold	170
COA of property to the company	80

  - Below is the computation of capital gains in respect of the transactions in different scenarios:

Particulars	Transaction A and B takes place in different year (assumption)		Transaction A and B takes place in same year (as in the case under consideration)	
	Year 1 [Transaction A]	Year 2 [Transaction B]	As per Revenue	As per taxpayer
Sales consideration	150	170	170	170
Less: COA	(100)	(150)	(80)	(100)
Capital Gains	**50** **[on transfer of shares]**	**20** **[on transfer of property]**	**90**	**70**

Total capital gains	**70**	**90**	**70**

- The transfer of shares (transaction A) was the first taxable event and since the taxpayer had received an asset other than money on liquidation, capital gains was to be computed by deducting the cost of shares from the FMV of the asset. The shares were acquired by the taxpayer himself and therefore, there was no question of adopting any cost to the previous owner. Further, the year of taxability would be the year in which the distribution of assets had taken place, i.e. the year in which the taxpayer received the asset which was FY 1990-91 corresponding to AY 1991-92.
- Transaction B pertained to the sale of property received by the taxpayer on liquidation. Though the taxpayer had sold the property in the same FY, i.e. in 1990-91, it was assumed that it was sold in FY 1991-92 i.e., in the subsequent FY. The question which arose was as to what the COA of the asset should be to compute capital gains. For this purpose, there are two provisions, viz., section 49(1)(iii)(c) and section 55(2)(b)(iii) of the ITA.
- Both the provisions provide for the COA of an asset which becomes the property of the taxpayer on the distribution of assets by a company on its liquidation. However, the applicability, of either of the provisions would depend on the situation in each case.

  If the taxpayer had been charged to capital gains tax on receipt of the property, then, as per section 55(2)(b)(iii), the COA would be the FMV of the asset on the date of distribution.

  If the taxpayer had not offered the capital gains for taxation in the year of accrual, then the COA would be as per section 49(1)(iii)(c) i.e., cost to previous owner.
- Thus, if the taxpayer offered capital gains as they arose, he would be paying tax on total capital gains of INR 70. However, if he offered capital gains for tax only in the year of sale of property received on distribution, he would end up paying more tax, i.e. on capital gains of INR 90. This could be taken to be the additional tax burden invited by the taxpayer himself for not offering to tax the capital gain arising in transaction A in the year in which the gain accrued.
- In point of time, transaction A occurs first and it is only as a result of transaction A, transaction B occurs. Therefore, while preparing the total computation of income, the taxpayer will first compute capital gains in transaction A and offer it for tax. Thereafter, the taxpayer will compute capital gains in transaction B and offer it for tax.

  Under these circumstances, it could be said that the taxpayer had been assessed to capital gains tax under section 46 and therefore, provisions of section 55(2)(b)(iii) will be applied, i.e. the FMV of the asset on the date of distribution could be taken as the COA.
- In the case under consideration, the taxpayer had practically done with a slight difference. Instead of making two computations, he had integrated both the computations into one. Thus, if capital gains arising in transaction A were treated as assessed to tax earlier, then, whether the computations were separately done or they were integrated into one, it would make no difference.
- Thus, the taxpayer had not postponed the taxability of capital gains but had offered it for tax in the same year in which the gains accrued. Therefore, it would be just and proper to accept the computation made by the taxpayer.

In view of the above, the HC held that the cost computed by the taxpayer as per section 55(2)(b)(iii) would be the proper methodology for computation of the COA.

Comments:

On liquidation of a company, its shareholders may receive money or assets. As per section 46 of the ITA, the shareholders are chargeable to tax under the head ‘capital gains’ in respect of FMV of the asset received on liquidation. Further, the sales consideration for the said section would be as reduced by the amount assessed under section 2(22)(c) of the ITA (relating to deemed dividend).

Issue arises as to what would be the COA in case of transfer of such asset since, sections 49(1)(iii)(c) and 55(2)(b)(iii) of the ITA, both provide for the COA of an asset received on liquidation.

This ruling has held / upheld the following:

- Both section 49(1)(iii)(c) and section 55(2)(b)(iii) of the ITA provide for the COA of an asset which becomes the property of the taxpayer on the distribution of assets by a company on its liquidation. However, the applicability, of either of the provisions would depend on the situation in each case.
- If the taxpayer had been charged to capital gains tax on receipt of the property under section 46, then, as per section 55(2)(b)(iii), the COA would be the FMV of the asset on the date of distribution. If the taxpayer had not offered the capital gains for taxation in the year of accrual, then the COA would be as per section 49(1)(iii)(c) i.e., cost to previous owner.

Taxpayers may want to evaluate the impact of this ruling to the specific facts of their cases.