HC holds if shares not alloted by end of the previous year in which succession takes place, section 47(xiii) is violated and exemption from capital gains can be withdrawn

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In brief

In a recent decision,[1] High Court (HC) of Karnataka held that for a transaction covered under section 47(xiii) of the Income-tax Act, 1961 (the Act), the condition (b) requiring allotment of shares has to be completed on or before the end of the previous year, i.e. before 31 March of the said year. The HC observed that the words ‘reasonable period’ cannot be stretched to cover a large period like three to four years. On harmonious reading of section 47(xiii) with section 47A of the Act, the HC upholds levy of capital gains tax in the hands of the successor company in respect of exemption claimed by the erstwhile firm.

In detail

Facts

- A partnership firm comprising of five partners was succeeded by the taxpayer company on 1 May 1999.
- The partners’ capital account balances were not equal.
- On 1 May 1999 the taxpayer company allotted some shares to all the partners in equal proportion.
- The final allotment of the said shares was made on 11 March 2003, resulting in shareholding of each partner equal to the balance standing to the credit of their respective capital accounts.
- According to the tax officer the requirement under section 47(xiii) of the Act “each partner becoming shareholder of the company in the same proportion in which their capital accounts stood in the books of the firm...” was not complied with and the capital gain arising on transfer of capital assets to the company was liable to tax.
- The Commissioner of Income-tax (Appeals) [CIT(A)] upheld the levy of capital gains tax.
- The Income-tax Appellate Tribunal upheld the CIT(A)’s order as the successor company would be liable to capital gains tax pursuant to section 47A(3) of the Act.
- Aggrieved, the taxpayer preferred appeal before the HC.

Issue before the High Court

Whether, in the absence of any specified time limit prescribed in section 47(xiii) clause (b) of the Act, allotment of shares to erstwhile partners of the firm in proportion to their capital accounts as per the books of the firm has to be made at the time of succession of the business by the company, or within a ‘reasonable period’ thereafter?

Taxpayer’s contention

The sum of INR 24 million

[1] ITA No. 884 of 2007 & 60 of 2015

was shown in the balance sheet as an amount pending allotment. Since the authorised capital of the company was not sufficient, the allotment of shares to the shareholders was kept pending.

- Clause (xiii) of section 47 of the Act is a beneficial provision that encourages corporatisation in the business world, and transfer of capital assets or intangible assets by the firm to a limited company was sought to be excluded from the tax net.
- In the absence of any specific time frame stipulated in clause (b) of the proviso to clause (xiii) of section 47 of the Act, even if the shares are allotted to the erstwhile partners of the firm in a staggered or phased manner, the compliance of the said condition of clause (b) should be deemed to have been satisfied.
- All other conditions of the aforesaid proviso were satisfied as the same five partners who were brothers of the same family became the shareholders of the company and their shareholding never fell below 50% for minimum holding period of five years.
- The allotment of shares over a period of three and half years from the date of succession i.e. 1 May 1999 could not be held to be a violation of provisions and contrary to the letter and spirit of provisions of the Act.
- The basic ingredient of levy of capital gains tax under section 45(1) of the Act was absent as there was no profit or gains in the hands of the company.
- In absence of specific time limit being prescribed, even the period of three to four years could constitute a 'reasonable period' for compliance with the conditions.

Revenue's contentions

- The process of allotment of shares should be completed on or before the date of succession of the business of partnership firm by the limited company, as it would otherwise defeat the very purpose of providing the exemption from tax under section 47(xiii) of the Act.
- The non-allotment of the shares to the erstwhile partners immediately upon succession of the business by the company may create complications as well as deprive such shareholders of their right to receive the dividends from the limited company from out of the profits of such limited company succeeding to the business of the partnership firm.

High Court's decision

- Section 47(xiii)(b) of the Act does not envisage the immediate allotment of shares in exchange of capital accounts balances of the partners of the partnership firm on or before the date of succession of business of partnership firm by the limited company.
- A 'reasonable period' of such process of allotment of shares by way of consideration to the partners in proportion to their capital account balance in the partnership firm has to be completed during the relevant previous year itself *viz.*, on or before the end of the previous year of 31 March of the said year, in which succession of the business takes place.
- The HC observed that providing for some period for completing the said process of allotment of shares is also reasonable and necessary to meet with the requirements of the provisions of the Companies Act.
- The words 'reasonable period' cannot be stretched to cover a large period like three to four years.
- Due to a delay of three to four years, the partners were deprived of their right to receive the dividends.
- If the allotment was completed at the time of succession or immediately thereafter, before the end of previous year on 31 March 2000 they would have become entitled to receive the dividends for the financial year ending on 31 March 2000. However, since the last allotment of shares was made on 11 March 2003, they were deprived of such an opportunity for three consecutive years.
- According to the provisions of the Act, the company in the present case was rightly held liable for the capital gains tax liability by virtue of section 47(A)(3) of the Act read with section 47(xiii)(b) of the Act.

The takeaways

Section 47(xiii) (b) of the Act does not prescribe the time limit for allotment of shares by the company to the erstwhile partners of the firm. In the instant case, the Karnataka HC has held that the allotment should be completed by the end of the relevant previous year in which the succession takes place.

Let's talk

For a deeper discussion of how this issue might affect your business, please contact your local PwC advisor

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