



9 May 2025

Cost of acquisition of assets to be at FMV, if shareholder is charged capital gains tax on receipt of such assets in case of liquidation – Madras High Court

In brief

The Madras High Court¹, while deciding regarding the cost of acquisition of assets in the hands of the taxpayer (shareholder of the liquidating company) received on distribution upon liquidation of a company, has held that if the taxpayer has been charged to tax upon receipt of the asset under section 46(2) of the Income-tax Act, 1961 (the Act), then the fair market value (FMV) of such asset will be deemed to be the cost of the asset in the hands of the taxpayer in terms of sections 55(2)(b)(iii) and 49(1)(ii)(c) of the Act (cost to the previous owner) should not be applicable. However, if the taxpayer has not been taxed under section 46(2) of the Act, then the cost of the asset received by the taxpayer will be the same as the cost to the previous owner (i.e. the cost in the hands of the company).

In detail

Facts

- The company under liquidation had three shareholders each of whom held 120 shares in the company acquired at INR21,000 per share.
- Pursuant to liquidation, an immovable property, valued at INR1,36,51,000 was distributed to the taxpayers proportionately.
- Each taxpayer received INR32,76,240 worth of immovable property as part of the distributed asset. No deemed dividend under section 2(22)(c) of the Act was assessed in these cases.
- Each of the taxpayers declared capital gains of INR7,56,240 arising pursuant to the sale of the asset after considering the cost of acquisition based on its FMV under section 55(2)(b)(iii) of the Act.
- The Tax Officer (TO) recomputed the cost of acquisition of the asset as per section 49(1)(iii)(c) of the Act at INR32,69,795.
- The taxpayers filed an appeal to the Commissioner of Income-tax (Appeals) [CIT(A)], wherein the addition made by the TO was deleted. The Revenue then filed an appeal against the CIT(A)'s order before the Income-tax Appellate Tribunal (Tribunal).
- The Tribunal allowed the Revenue's appeal following the co-ordinate bench ruling in the case of Mrs. Lakshmi Muthukrishnan. In case of the third taxpayer², the Tribunal observed that if a taxpayer paid

¹ T.C.A.Nos. 438 of 2008, 34 of 2009 & 5 of 2010

² ITA No.1388/MDS/1998 for AY 1991-92 dated 20 November 2009

taxes under section 46(2) of the Act, then the cost of the asset in the hands of the taxpayer should be the FMV of the asset. However, on the same basis as in the case of the other two taxpayers, the Tribunal allowed the Revenue's appeal.

Issue before the High Court

Whether the cost of acquisition of asset received by a shareholder pursuant to the liquidation of a company should be determined in terms of section 55(2)(b)(iii) of the Act (i.e. at FMV) or in terms of section 49(1)(ii)(c) of the Act (i.e. cost in the hands of the liquidating company)?

High Court's decision

- A unique factor in the taxpayer's case is that both sections 49(1)(ii)(c) and 55(2)(b)(iii) of the Act would stand attracted.
- Two transactions chargeable to tax took place in the same financial year. First, by way of extinguishment of right in the shares held pursuant to liquidation in consideration of which the taxpayers received the asset from the company (Transaction 1). Second, by transfer of the asset received on liquidation and in consideration of which the taxpayers received actual money (Transaction 2). As observed by the Tribunal, for Transaction 1, the year of taxability will be the year of distribution of assets. Hence, the FMV of the asset received reduced by the cost of acquisition of the shares will be chargeable to capital gains in the hands of the taxpayers.
- The Tribunal had further observed that, in this case, the provisions of both sections 49(1)(ii)(c) and 55(2)(b)(iii) of the Act are attracted.
- As both taxable events have occurred in the same financial year, it is deemed that Transaction 2 occurred after Transaction 1. Accordingly, the Tribunal had agreed that the cost of acquisition of the asset received by the taxpayers on liquidation of the company will be determined in accordance with section 55(2)(b)(iii) of the Act, but it allowed the department appeal holding otherwise in view of the earlier decision of the co-ordinate bench.
- It was held that a Tribunal should have referred the matter for the constitution of a larger bench instead of allowing the Revenue's appeal.
- The court concurred with the discussion and conclusion of the Tribunal about the determination of cost under section 55(2)(b)(iii) of the Act. The court also held that, as both the transactions are in the same year, it will not matter whether the computation of capital gains for two transactions are made separately or a single computation is made, as computed by the taxpayer.

The takeaways

This is a welcome decision from the Madras High Court which categorically concurred with the view of the Tribunal about the situations under which the two conflicting provisions of sections 49(1)(ii)(c) and 55(2)(b)(iii) of Act are applicable for the purpose of determining the cost of the assets in the hands of the taxpayer received pursuant to liquidation. This clarifies that if the transaction relating to the receipt of asset is charged to tax, the FMV of the capital asset should be available as cost for the purpose of computing capital gains on the transfer in the future.



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KA-September 2024-M&C 40853