

Sharing insights

News Alert
11 July, 2012



Surplus arising on amalgamation by adopting purchase method of accounting not taxable as business income under section 28(iv) of the Income-tax Act, 1961

In brief

In a recent ruling in the case of Spencer and Company Ltd. (the assessee)¹, the Third Member of the Chennai Bench of the Income-tax Appellate Tribunal (the Tribunal) held that any surplus arising on amalgamation, (i.e. difference between net market value of assets and face value of shares, transferred to general reserve), is not taxable as business income under section 28(iv) of the Income-tax Act, 1961 (the Act).

Facts

- Spencer Industrial Fund Ltd. (SIFL) was amalgamated with the assessee with effect from 1 April, 2001, under a scheme of amalgamation.
- The Madras High Court (HC) passed an order approving the scheme of amalgamation on 25 October, 2002.
- The assets and liabilities of SIFL were recorded in the assessee's books at their fair value. This resulted in a surplus of INR 289.9 million in the books of the assessee company which was credited to general reserve.

¹ Spencer and Company Ltd. v. ACIT [ITA No.440/Mds/2011, order dated 1 May,2012]

- The assessing officer (AO) did not treat this surplus as part of the assessee's income during the assessment. However, the Commissioner of Income-tax (CIT) observed that the surplus was not taxed as business income under section 28(iv) of the Act and proposed to revise the assessment on the grounds that it was erroneous and prejudicial to the interest of the Revenue.

Assessee's contentions

Amongst other objections relating to the period of limitation, the assessee contended that:

1. The excess of fair value of net assets taken over which was transferred to general reserve was purely an accounting entry and is not subject to income tax. Even if it were held to be taxable, income arising on amalgamation should be taxed as capital gains rather than as profits and gains of business or profession.
2. According to section 28(iv) of the Act, '*the value of any benefit or perquisite, whether convertible into money or not, arising from business or the exercise of a profession*' is taxable under the head 'Profits and gains of business or profession'. In the case under discussion, no benefit or perquisite arose from carrying on a business activity. Instead, benefit arose in the course of acquiring a capital asset. Therefore, excess value of net assets transferred to the general reserve is not taxable under section 28(iv) of the Act.

CIT's ruling

- The CIT held that once the SIFL's business was carried on by the assessee, the excess of INR 289.9 million which arose on amalgamation, should be assessed as business income.

- In particular, he relied on the case of Aries Advertising Co. Pvt. Ltd.², where the Madras HC held that the transfer of any amount to general reserve was to be treated as profits of the business. Reliance was also placed on the case of Vazir Sultan Tobacco Co. Ltd.³.
- The CIT directed the AO to assess INR 289.9 million as business income in the hands of the assessee.

Tribunal ruling

The Two Members of the ITAT differed in their conclusion.

The Judicial Member held that surplus of INR 289.9 million should be treated as business income. Reliance was placed on the case of Aries Advertising Co. Pvt. Ltd. (above) following the judgement of the Supreme Court in the case of Vazir Sultan Tobacco Co. Ltd. (above), in which it was held that the transfer of any amount to the general reserve was to be treated as business profit.

The Accountant Member held that the surplus amount of INR 289.9 million should not be treated as business income. The benefit or perquisite of section 28(iv) of the Act must arise from business or the exercise of a profession and should be in the nature of a trading receipt; that is, it must arise from the actual conduct of the business itself.

Owing to the difference of opinion between the two Tribunal members, a reference was made to the Third Member.

The Third Member of the Tribunal agreed with the opinion of the Accountant Member that the surplus of INR 289.9 million is not in the nature of any benefit or

² CIT v. Aries Advertising Pvt. Ltd. [2002] 255 ITR 510 (Mad)

³ Vazir Sultan Tobacco Co. Ltd. v. CIT [1981] 132 ITR 559 (SC)

perquisite and is not, therefore, taxable as business income under section 28(iv) of the Act. He gave the following reasons for his decision:

- A similar issue was considered in the case of Quintegra Solutions Ltd.⁴, in which it was decided that the differential amount arising on amalgamation was merely a balancing figure adjusted in the books of the amalgamated company and not taxable as business income.
- The Third Member also agreed with the Accountant Member that the cases of Aries Advertising Co. Pvt. Ltd. and Vazir Sultan Tobacco Co. Ltd. were not applicable to the present case.
- Furthermore, if the surplus was to be considered as a capital transaction, it could not under section 47(vi) of the Act, be taxed as capital gains, since amalgamation is not treated as 'transfer' for the purposes of section 45 of the Act.

Conclusion

The character of a receipt does not depend upon the accounting treatment used by the assessee in its books of account. Tax is to be levied according to the actual character of the receipt and not merely on the basis of accounting treatment used by the assessee.

⁴ Quintegra Solutions Ltd v. ITO [ITA Nos.1526 to 1530 & 2056/Mds/2010, order dated 21 September, 2011]

Our Offices

For private circulation only

<p>Ahmedabad President Plaza, 1st Floor Plot No 36 Opp Muktidham Derasar Thaltej Cross Road, SG Highway Ahmedabad, Gujarat 380054 Phone +91-79 3091 7000</p>	<p>Bangalore 6th Floor, Millenia Tower 'D' 1 & 2, Murphy Road, Ulsoor, Bangalore 560 008 Phone +91-80 4079 7000</p>	<p>Bhubaneswar IDCOL House, Sardar Patel Bhawan Block III, Ground Floor, Unit 2 Bhubaneswar 751009 Phone +91-674 253 2279 / 2296</p>	<p>Chennai PwC Center, 2nd Floor 32, Khader Nawaz Khan Road Nungambakkam Chennai 600 006 Phone +91-44 4228 5000</p>	<p>Hyderabad #8-2-293/82/A/113A Road no. 36, Jubilee Hills, Hyderabad 500 034, Andhra Pradesh Phone +91-40 6624 6600</p>
<p>Kolkata South City Pinnacle, 4th Floor, Plot – XI/1, Block EP, Sector V Salt Lake Electronic Complex Bidhan Nagar Kolkata 700 091 Phone +91-33 4404 6000 / 44048225</p>	<p>Mumbai PwC House, Plot No. 18A, Guru Nanak Road - (Station Road), Bandra (West), Mumbai - 400 050 Phone +91-22 6689 1000</p>	<p>Gurgaon Building No. 10, Tower - C 17th & 18th Floor, DLF Cyber City, Gurgaon Haryana -122002 Phone : +91-124 330 6000</p>	<p>Pune GF-02, Tower C, Panchshil Tech Park, Don Bosco School Road, Yerwada, Pune - 411 006 Phone +91-20 4100 4444</p>	<p>For more information contact us at, pwctr.knowledgemanagement@in.pwc.com</p>

The above information is a summary of recent developments and is not intended to be advice on any particular matter. PricewaterhouseCoopers expressly disclaims liability to any person in respect of anything done in reliance of the contents of these publications. Professional advice should be sought before taking action on any of the information contained in it. Without prior permission of PricewaterhouseCoopers, this Alert may not be quoted in whole or in part or otherwise referred to in any documents

©2012 PricewaterhouseCoopers. All rights reserved. "PwC", a registered trademark, refers to PricewaterhouseCoopers Private Limited (a limited company in India) or, as the context requires, other member firms of PricewaterhouseCoopers International Limited, each of which is a separate and independent legal entity.