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Sale of shares by the promoters not sale of investment but sale of entire business and thus taxable as business income

In brief

In a recent decision in the case of Sumeet Taneja[1] (the assessee), the Chandigarh Income-tax Appellate Tribunal (the Tribunal) held that sale of shares of a company by its promoters is taxable as business income and not as capital gains as sales consideration includes non-compete premium because of which the assessee is prevented from doing similar/same business. Therefore, the transfer in effect involves sale of the entire business.

Facts

- The assessees sold their entire holding in a non-listed company, Excel Callnet Pvt. Ltd. (the company) and offered the long-term capital gains to tax.
- The assessing officer (the AO), relying on the share purchase agreement, treated the gain on sale of the shares as income under the head 'profits and gains of business or profession' (PGBP) on the following grounds:
  - The transaction of shares in effect entails transfer of management of the company in favour of the purchaser.

[1]Sumeet Taneja *v.* ACIT [TS-412-ITAT-2012 (Chandi)]

- The transaction entails transfer of employee database, products database, customer support, new client proposals in pipeline, other prospects and customer's database, payment recovery and customer, management cases, contract, verbal commitments, banking information, software/licenses and any other property that is acquired under the tenure of the sellers working with the company.

- Non-compete covenants:

  - Restriction on seller to engage in any similar business within a radius of 100 kms from Chandigarh for a period of two years.

  - The seller is further restricted to use the brand equity of the company by using any names, logos, trademarks, partnerships, affiliations, domain of websites, etc.

  - Restriction on seller from poaching employees of the company or of the purchaser.

- Mutually agreed price consideration was INR 94/- per share whereas the book value per share was INR 7.29/- only.

- The purchaser paid the consideration amount in three instalments.

- Thus, transfer of the share was not the transfer of capital asset within the meaning of section 2(14) of the Income-tax Act, 1961 (the Act) but was in fact a transfer/renunciation of control over the company in favour of the purchaser.

- The AO further argued that the case of the assessee also is not covered within the ambit of 'slump sale' as defined in section 2(42C) of the Act as only the equity of the company was sold and no liability of the seller was taken over by the purchaser.

- Therefore, the transaction could not be taxed under sections 45 or 50B of the Act pertaining to capital gains but is taxable under section 28(va) of the Act (i.e. pertaining to PGBP).

- The Commissioner of Income-tax (Appeals) (CIT(A)) upheld the order of the AO on the ground that the promoters were not merely investors in the company, rather they were carrying day to day management of the company and this was the main reason for insertion of non-compete clause in the share purchase agreement.

Issue

- Whether amount received on sale of equity shares of the private limited company by its promoters is assessable as income under the head capital gains or PGBP?

Assessee's contentions

- The transaction was merely a case of sale and purchase of investment and consequently gains arising on such transfer are taxable under the head 'capital gains'.

- The investment made in the company was reflected as an investment in the balance sheet from year to year.

- It was only the company which was doing the business and not the promoters and the promoter's income was from salary.

- Investment in the company was for earning income from dividend and not for trading in shares.

- Provisions of section 28(va) of the Act would be attracted where the assessee was carrying on the business and not where the assessee only had the right to carry on the business in the form of capital asset .

- Non-compete clauses in the agreement were only incidental to the agreement and no consideration was received for same.

- Price settled between the parties was only the market price of the shares.

Revenue's contentions

- The agreement between the parties was both for transfer of shares and for non-competition and was in the nature of income assessable under section 28(va) of the Act i.e. an agreement for not carrying out any activity in relation to any business.

Tribunal ruling

- The Tribunal observed that consideration for sale of share includes non-compete premium for not engaging in similar/same business as that of the company within a radius of 100 kms from Chandigarh for a period of two years from the date of agreement.

- The seller also agreed not to solicit business of the company without prior written permission of the purchaser.

- It is apparent that the transaction in question was in the nature of purchase of business by the purchaser involving transfer of management of the company to the purchaser with a rider of non-interference and renunciation of the management by the sellers.

- The transaction would entail handing over responsibilities to the purchasers including employee and product data base, customers support contracts, verbal commitments as well as new clients' proposals.

- If it was merely a case of sale of investment by the shareholders, then the aforementioned exercise was not required.

- Even the sale consideration agreed upon between the parties, including the consideration on account of non-compete covenant, was paid in instalments over a period of time.

Conclusion

Based on the overall reading of the terms of agreement between the parties, like non payment of consideration upfront, fixation of agreed sale price higher than the market price and non-compete covenants, the Tribunal held that the transaction of sale of shares was not mere transfer of capital asset but was in fact transfer of business of the assessee as it was prevented from doing similar/same business and also had to give up its right to do business.

Although the Tribunal held that the transaction of sale of shares was a case of transfer of business, the argument that business itself was a capital asset and thus its transfer would entail capital gains was not discussed.

The ruling is relevant for promoters who have sold their shares in their promoter company and have received non-compete premium as part of the sale consideration.

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