Tax incidence on distribution of assets in case of liquidation of a company

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There have always been some issues arising regarding the taxability in the event of liquidation of a company, of distribution of assets to its shareholders, both in the hands of the company as well as the shareholders. The Income Tax Act provides specific provisions with regard to taxability of such incidents. The common perception has always been that the shareholders being the owner of the company why would any transfer from company to its shareholder would be taxable either in the hands of the company or in the hands of shareholders.

Section 46 of the Income Tax Act is the main provision providing for taxability in such instances.

"Capital gains on distribution of assets by companies in liquidation.

46. *(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."

Section 46(1) enacts that a company cannot be regarded as having made any capital gains if it merely distributes its assets among its shareholders on liquidation. This sub-section applies only to distribution of assets in specie by a company in liquidation among its shareholders.

There has always been a dispute with respect to the fact that the distribution of assets in the hands of shareholders, since the transaction does not come under the ambit of the term 'transfer' as defined under section 2(47) of the Income Tax Act, as there is neither sale, exchange, relinquishment nor extinguishment of any rights, then how can this be an instance of charging as income under the head 'capital gains'.

Ordinarily operating section 45, to consider any transaction to be a transfer of capital asset by any of the modes referred to in section 2(47) of the Act, apart from the legal fictions created therein, envisages passing of consideration from one hand to another and passing of rights, notwithstanding extinguishment in the hands of the transferor to the transferee, whether in the form of tangible gain or augmentation of the existing rights of others. It was because of this, on liquidation return of corpus to the shareholders, who were otherwise entitled to the same as a matter of right, cannot be said to be transfer in terms of section 2(47), because on extinguishment of their rights in the shares and their having received cash or assets in the place of rights which they held in the shares, no corresponding rights accrue in any one for that consideration.

However, the controversy was put to rest by the hon'ble Supreme Court holding that section 46(2) is in terms an independent charging section. It also provides for a distinct method of calculation of capital gains. As said in **CIT v. R.M. Amin [1977] 106 ITR 368 (SC)**, therefore has to be read on its own, notwithstanding section 2(47).

"The aforesaid section, in our view, was enacted both with a view to make shareholders liable for payment of tax on capital gains as well as to prescribe the mode of calculating the capital gains to the shareholders on the distribution of assets by a company in liquidation. But for that sub-section, as already mentioned, it would have been difficult to levy tax on capital gains to the shareholders on distribution of assets by a company in liquidation."

Further, while holding that section 46(2) is a sort of complete code in itself, the Hon'ble Supreme Court in the case of **N Bagavathy Ammal Vs. CIT (2003) 259 ITR 678 (SC),** observed as under:

"Therefore, to the extent that a shareholder assessee receives assets whether capital or any other from the company in liquidation, the assessee is liable to pay tax on the market value of the assets as on the date of the distribution as provided under section 46(2). That appears to be the plain meaning of the section and we see no reason to construe it in any other fashion. The invocation of section 2(14) of the Act which defines "capital asset" is as such unnecessary for the purpose of construing section 46(2).

That is to say, for the purpose of computing capital gains, there has to be existence of a capital asset. A transaction has to be treated as its transfer resulting in sale or extinguishment of any right therein and the full value of the consideration has to be adjusted against cost of acquisition of the assets so transferred and the balance is to be treated in accordance with the provisions of the Act. For giving effect to the fiction enacted under section 46(2), all the necessary requirement too has to be assumed to be existing, if the fiction is to be carried to its logical end."

Section 48 provides for the mode of computing income under the head "Capital gain". The mode of computation shorn of all technicalities and other complexities is to deduct from the full value of the consideration received or accruing as a result of the transfer of the capital asset, the cost of acquisition of the asset. Section 46(2) which has also been held to be the charging section for bringing the result of receipts by shareholders of a company on its liquidation too provides for computation of capital gains in accordance with section 48, for which receipt or value of asset after deducting sum assessed as dividend under section 2(22)(c), if any, is to be deemed to be the full value of the consideration.

FULL VALUE OF CONSIDERATION:

Since sub section (2) is very unambiguous in charging the amount "*in respect of the money so received or the market value of the other assets on the date of distribution,",* there have not been much issues arising on this. However, a question arose as to the manner in which the attached liabilities transferred to the shareholders are to be

treated, in the case of **CIT Vs. Shri Nayan Arvind Shah, Bom HC, INCOME TAX APPEAL NO.1856 OF 2009, 1857 OF 2009, 1858 OF 2009.** On the facts and circumstances of the case, hon'ble court observed as under:

> *"3. In the present case, the finding of fact recorded by the Income Tax Appellate Tribunal is that the liquidator of the Company distributed the assets of the Company to the shareholders with the liabilities attached to that asset, as liquid funds were not available with the Company for discharging the liabilities attached to the asset. It was open to the liquidator to sell the assets and after discharging the liabilities attached to the asset, distribute the balance amount amongst the shareholders. In the present case, the liquidator has distributed the assets to the shareholders leaving it to the shareholder to discharge the liabilities attached to that asset. In the present case, the fact that the assets were transferred to the shareholders with liabilities attached to it is not in dispute. The fact that the shareholders have in fact discharged the liabilities attached to the asset is also not in dispute. In these circumstances, the decision of the Tribunal that where an asset of the Company in liquidation is distributed to the shareholder with a specific liability attached to it, then the value of the asset for the purposes of Section 46(2) of the Act should be the full value of the asset as reduced by the amount paid by the shareholder for discharging the liability attached to the asset cannot be faulted."*

It is quite logical also that if the liabilities of the company in dissolution are also transferred to the shareholders together with the assets, the value of such liabilities are to be reduced from the value of money and other assets so distributed.

COST OF ACQUISITION

After having the amount of 'full value of consideration' the next question arises as to what is to be taken as 'cost of acquisition' while computing income under the head 'capital gains' in such a scenario. Very logically the cost of acquisition of shares at the time these were acquired are to be taken as cost of acquisition while computing capital gains.

PERIOD OF HOLDING/YEAR OF CHARGE

There should not be any confusion in computing the period of holding and the year of charge. Period of holding is the period computed from the date on which the shares were acquired by the shareholder and the date of dissolution when the money and assets were transferred to the shareholder. On that it can be decided whether it results in short term or long term capital gains. It is to be noticed that section 46 mandates the transaction to be treated as 'capital gains' in the hands of shareholders, nowhere it prescribes it to be short term/long term, therefore normal provisions are to be applied here.

Year of charge is very clear the year of dissolution of the company when the assets were transferred to the shareholder. It is also coming out from the provisions of section 46.

SECTION 2(22)(c)

Very clearly the provisions of section 46 provides for exclusion of the amount assessed under section 2(22)(c), while computing such capital gains. Therefore, one must understand what the section 2(22)(c) says:

(22) "dividend" includes-

(c) any distribution made to the shareholders of a company on its liquidation, to the extent to which the distribution is attributable to the accumulated profits of the company immediately before its liquidation, whether capitalised or not ;

The section is too clear to the effect that to the extent of accumulated profits the company possesses at the time of dissolution that amount has to be treated as dividend and only the excess amount is to be assessed under the head 'capital gains'. There is a logic in this provision. As we know that a shareholder is one of the owners of the company and shares are possessed by him as his part of the business of the company. That means every shareholder has a right to share in the profits/losses earned by the company at any point of time and this share in income is termed as dividend. However, most of the times companies do not distribute whole of the profits earned by them and accumulate a part of its income mainly to be ploughed back in the business. This remaining amount is represented by accumulated profits appearing in the balance Sheet of the company at the time of dissolution. Since this is a part of income of the company and shareholders are rightly having the right on this as

dividend it cannot be termed as capital gain. Therefore, this amount represents the dividends and has to be taxed accordingly.

IN LIQUIDATION – before or after

With regards to the above stated position of law it should be noted that the above section 46 makes use of the words *"on liquidation"* and not *"in liquidation".* Thus, the liquidation should be completed before any assets are distributed.
Hon'ble Gujarat High Court in the case of CIT Vs. Jaikrishna Harivallabh (1998) 231 ITR 108 (Guj), observes in this context:

"In the case of piecemeal distribution of cash or assets which have been left surplus after the discharge of liabilities, it cannot be said that the rights of the shareholders are extinguished before the affairs of the company are wound up, so as to give effect to the expression "full value of consideration" for the purpose of section 48. "Full value of consideration" and its adjustment against cost of acquisition of asset deemed to have been transferred (in the present case by extinguishment of rights to receive surplus, if any), are two essential ingredients for computation of capital gains under section 48. In that situation, the only reasonable inference to be drawn is that the expression "on liquidation" under section 46(2) refers to the date when the affairs of the company are completely wound up and the right of the shareholder to return of capital after discharge of the liabilities of the company and preferential payments comes to an end. It may further be noticed that the entire receipts, whether in cash or in the form of assets, are not to be taxed only as capital gains under the head "Capital gains" but part of it is referable to the distribution of accumulated profits, which are liable to be taxed as dividends in accordance with the provisions of section 2(22)(c) and the same has to be deducted from the cash or market value of assets received and only the balance is to be treated as "full value of consideration" for extinguishment of rights of shareholders as on that date to be fixed under the head "Capital gains".

"The contention that this provision should apply to actual receipts only also cannot be accepted for yet another reason, because acceptance of that would lead to an incongruous and anomalous result as will be seen presently. The acceptance of this view would mean whereas even in a case where a sum is received, howsoever negligible or insignificant it may be, it would result in the computation of capital gains

or loss, as the case may be, but in a case where nothing is disbursed on liquidation of a company the extinction of rights, would result in total loss with no consequence. That is to say on receipt of some cost, however insignificant it may be, the entire gamut of computing capital gains for the purpose of computing under the head "Capital gains" is to be gone into, computing income under the head "Capital gains", and loss will be treated under the provisions of Act, but where there is nil receipt of the capital, the entire extinguishment of rights has to be written off, without treating under the Act as a loss resulting from computation of capital gains, The suggested interpretation leads to such incongruous result and ought to be avoided, if it does not militate in any manner against object of the provision and unless it is not reasonably possible to reach that conclusion. As discussed above, once a conclusion is reached that extinguishment of rights in shares on liquidation of a company is deemed to be transfer for operation of section 46(2) read with section 48, it is reasonable to carry that legal fiction to its logical conclusion to make it applicable in all cases of extinguishment of such rights, whether as a result of some receipt or nil receipt, so as to treat the subjects without discrimination. Where there does not appear to be ground for such different treatment the Legislature cannot be presumed to have made deeming provision to bring about such anomalous result."

Viewed from the aforesaid angle, one must reach the conclusion that as on the date, the affairs of the company are fully wound up and the entitlement of the shareholder to any return of its capital comes to an end, any disbursement made to a shareholder either by way of cash or asset has to be treated in the hands of the recipient shareholder as the full value of consideration on deemed transfer of his capital asset, as a result of extinguishment of all rights has to be deemed to be resulting in capital gain or loss, as the case may be, as per the result of computation made under section 48 of the Act. The amount which a shareholder is entitled from a running company, i.e. before the liquidation is his dividend, while amount received after winding up may result in capital gains/losses as per the provisions of section 46(2).

CARRY FORWARD OF LOSSES

As has been held by the hon'ble Supreme Court that section 46(2) creates a legal fiction, once a legal fiction is created to treat the receipt or assets on distribution of liquidation in the hands of a shareholder, it inheres transfer of assets by

extinguishment of rights, by the recipient of consideration and once that fiction comes into existence it must lead to its logical conclusion in the computation of capital gains in accordance with the provisions of the Act, whether the ultimate result is found to be a gain or loss.

Hon’ble Gujarat High Court in the case of CIT Vs. Jaikrishna Harivallabh (1998) 231 ITR 108 (Guj)

“Consideration in the ordinary sense means something in lieu of or exchange of. It does not provide, that on computation of capital gain as per section 48, the surplus if any only is to be charged to tax as capital gains. This is how it was suggested to us to read the provision. On the contrary, the provision in question section 46(2) does not provide any such further inhibition against treatment of the balance. Such balance resulting as per computation made in accordance with section 48 has to be subjected to charge of tax as per the provisions of the Act. Section 71 of the Act envisages where computation under any head of income is a loss, the assessee is entitled to set off such loss against computation of income assessable under other head for that year. Section 74 specifically provides that where in respect of any assessment year, the net result of computation under the head "Capital gains" is a loss to the assessee, the same may be carried forward, if it cannot be set off against income of that year. Thus the computation of income under any head, including under the head "Capital gain", envisages a situation where such computation may result in negative balance or loss. In other words, computation of income chargeable to tax includes computation of loss as well, for the purpose of levy of tax in accordance with the provisions of the Act and to be treated accordingly. There is nothing in the provision of section 46(2) which excludes the applicability of other provisions of the Act dealing with set off and carry forward of loss under any head of income to the computation of income chargeable to tax under the head "Capital gains" under it.”

In view of the above, quite logically, it is to be understood that in case a shareholders incurs losses on receipt of assets from a company on liquidation, as per the provisions of section 46(2), the same are to be treated as normal loss under the head ‘capital gain’ and to be treated as per law.

FURTHER TRANSFER OF SUCH ASSETS BY THE SHAREHOLDER

The period of holding to be computed at the time of subsequent sale of such assets received by a shareholder at the time of dissolution is simply the time gap between the transfer and the date of dissolution when the assets were transferred to him by the company. As this is not one of the circumstances mentioned in any of the clauses of section 49. Therefore no need to add any extended time. Further the fact that the assessee was subjected to ‘capital gains’ tax at the time of acquisition of such assets, no further period to be added.

Cost of acquisition is defined under section 55(2)(b)(iii), which reads as under:

Section 55(2)(b)(iii)

(2) For the purposes of sections 48 and 49, "cost of acquisition",-

*(b) in relation to any other capital asset,-**]***

(iii) 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 ;

The section is too unambiguous to provide that the cost of acquisition while computing capital gain in case of receipt of certain assets by the shareholders at the dissolution of the company has to be the fair market value of the asset. Definitely in this situation the cost of acquisition at the time of this transfer has to be taken as the fair market value of assets at the time of receipt of these assets, which is also the amount which was considered as sale consideration, while taxing the capital gains at first instance.

CONCLUSION

Law is very clear on the issue of chargeability of income tax at the time of distribution of assets to shareholders in case of liquidation of a company. Ample judicial intervention is also available on the same. Therefore, there should not be any difficulty in computing the chargeability of tax in such circumstances.