Capital gains exemption denied since share allotment not made in a 'reasonable period'

The Karnataka High Court ('High Court') in the case of Prakash Electric Company[1] has recently passed a judgement which provides guidance on an issue which previously had little litigative history.

The High Court has ruled in the favour of the Revenue and concluded that in absence of any statutory timelines for issue of shares pursuant to restructuring, the conditions for obtaining the benefit of tax neutrality under the provisions of the Income-tax Act, 1961 ('Act') are to be fulfilled in a 'reasonable period' of time.

Background and Facts

- Prakash Electric Company ('Assessee Firm'), a partnership firm, comprising of 5 partners, was succeeded in business by a private limited company, Prakash Electric Company Private Limited ('Successor Company') on 1 May 1999.

- The partners of the Assessee Firm were allotted shares in the Successor Company against their interests in the partnership firm in a phased manner as under:

Tranche	Date	Allotment
First	Subscription to memorandum	10 equity shares of Rs. 10 /- by each partner
Second	1 May 1999	6,000 equity shares of Rs. 10 /- each
Third	11 December 2002	4,000 equity shares of Rs. 10 /- each

[1] ITA No. 884/2007 c/w ITA No. 60/2015

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Fourth	11 March 2003	18,50,000 equity shares of Rs. 10/- each at a premium of Rs. 2.97 / share in the proportion of the capital account balances of the partners in the Assessee Firm.

- The Assessee's claim was that the succession of the business was carried out in a manner that was compliant with section 47(xiii) of the Act and thus there would be no capital gains on the transfer of business from the Assessee Firm to the Successor Company.

- However, the Assessing Officer ('AO') opined that the phased allotment of shares was a violation of the condition provided in clause (b) of the proviso to section 47(xiii) of the Act. The relevant extract of the proviso to section 47(xiii) of the Act is reproduced below:

  "(b) all the partners of the firm immediately before the succession become the shareholders of the company in the same proportion in which their capital accounts stood in the books of the firm on the date of the succession;"

  Accordingly, the AO brought to tax capital gains on the transfer of business in the hands of the Assessee Firm.

- On appeal, the First Appellate Authority upheld the levy of capital gains tax on the Assessee Firm. On further appeal, the Second Appellate Authority upheld the levy of capital gains tax but having regard to the provisions of section 47A(3) of the Act held that the Successor Company and not the Assessee Firm be liable to pay the capital gains tax.

- Aggrieved by the decision of the Second Appellate Authority, the Assessee Firm preferred an appeal to the High Court.

Ruling of the High Court

- In the current case, the authorised share capital of the Successor Company was not suitably increased to allot shares to the partners of the erstwhile Assessee Firm and the consideration was credited to "Shareholders Fund Account" in the books of the Successor Company. The learned counsel for the Assessee Firm argued that where no specific time limit is prescribed for compliance of the condition in clause (b) of the proviso to section 47(xiii) of the Act, a reasonable period should be allowed to the Assessee to complete with the process of allotment of shares. Given the above, the Assesse Firm claimed that even a period of 3-4 years could constitute a reasonable period.

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- The High Court appreciated the fact that section 47(xiii) of the Act does not provide a specific timeline for the allotment of shares to the partners of the erstwhile partnership firm. The High Court further noted that process of closing of the books, determination of the exact capital balances of the partners of the erstwhile partnership firm and allotment of shares by passing appropriate resolutions may take some amount of time and thus the legislature has advisedly not provided for a specific time limit in section 47(xiii) of the Act.

- Having regard to the above, the High Court held that the word 'reasonable period' cannot be stretched to cover a large period like 3-4 years. Further, the reason provided by the Assessee was not a sufficient reason to delay the process of allotment of shares to such an extent. In the learned opinion of the High Court the allotment of shares has to be completed during the relevant previous year itself i.e. in the year in which the succession of business of the partnership firm by the company takes place.

- Finally, the High Court concluded that on a reasonable and harmonious construction of the relevant provisions of the Act (i.e. section 47A(3) and section 47(xiii) of the Act), the Second Appellate Authority had rightly held the Successor Company liable to capital gains tax.

Dhruva comments

- Allotment of shares for ensuring tax neutrality of a restructuring exercise is a pre-condition in several sections of the Act [eg. section 2(1A) – Amalgamation, section 2(19AA) – Demerger, section 47(xiii) – succession of business of partnership by a company, section 47(xiiib) – conversion of partnership firm into a limited liability partnership, etc]. However, none of these sections provide a statutory timeline for such allotment of shares.
- The High Court has interpreted the provisions of section 47(xiii) of the Act and has suggested that in case of succession of business, the 'reasonable period' for allotment of shares shall be till the end of the previous year in which the succession of business takes place. However, it should not be concluded that 'reasonable period' expires at the end of the previous year where restructuring of business takes place at the fag end of the financial year (eg. 15 March). In such a scenario, we believe, a literal interpretation of this decision will provide absurd results. In our opinion, the 'reasonable period' would mean the few months required to complete the necessary corporate compliances and where these few months stretch into the next financial year the assessee should be prepared to provide to the assessing authority a sufficient business / commercial rationale to justify such 'reasonable period'.

- This decision provides a valuable judicial guidance on time period to allot shares pursuant to succession, merger, demerger, any other restructuring. In such situations, the assessee can make allotment of shares in a reasonable period which can extend atleast till the end of the previous year in which such restructuring is made effective.

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