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DIRECT TAX ALERT

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Supreme Court: Receipt of shares pursuant to an amalgamation, in exchange of shares held as stock-in-trade, results in taxable business income for the shareholders

Supreme Court: Receipt of shares pursuant to an amalgamation, in exchange of shares held as stock-in-trade, results in taxable business income for the shareholders

Under a scheme of amalgamation, the shareholders of the amalgamating company receive shares of the amalgamated company ('new shares') in exchange for their shareholding in the amalgamating company ('existing shares'). Where such existing shares are held as stock-in-trade, the receipt of new shares, upon allotment, results in taxable business income in the hands of the shareholders. This is the case if new shares are of definite value in monetary terms, commercially realisable in money and the shareholders are in a position to freely dispose of or transfer such new shares.

Background

- The appellants¹ ('Taxpayer') are investment companies of Jindal Group, holding shares of operating companies, namely Jindal Ferro Alloys Limited ('JFAL') and Jindal Strips Limited ('JSL'), as promoter holdings representing controlling interest.
- Pursuant to scheme of amalgamation, JFAL was amalgamated with JSL wherein the Taxpayer, being shareholders of JFAL, were allotted shares of JSL in lieu of shares held by them in JFAL.
- The Taxpayer, treating the shares as capital assets, claimed exemption under Section 47(vii) of the Income-tax Act, 1961 ('the Act'). However, the Assessing Officer, treated the shares as stock-in-trade and taxed market value of the new shares as business income. The Appellate Authority upheld this view.
- On appeal, the Delhi Bench of the Income-tax Appellate Tribunal held that the nature of holding (whether as capital asset or stock-in-trade) was immaterial, as no profit accrues unless the shares are sold or transferred for consideration.
- Upon appeal, the Delhi High Court held that:
 - i. if shares are held as capital assets, receipt of new shares constitutes a 'transfer', which is exempt from levy of tax under Section 47(vii) of the Act; and
 - ii. if shares are held as stock-in-trade, receipt of new shares amounts to realisation of trading assets, leading to taxable business income under Section 28 of the Act.
- The Delhi High Court disposing the appeals in favour of the Revenue remanded the matter back to the Tribunal for determination of the nature of the Taxpayer's holding of JFAL shares.

Issue under consideration:

- Whether receipt of new shares, (being shares of the transferee company), pursuant to a scheme of amalgamation, gives rise to taxable business income, where the existing shares, being shares in the transferor company) were held as stock-in-trade?

Taxpayer's contention:

- Receipt of shares pursuant to amalgamation is neither a sale nor an exchange because the amalgamating company is dissolved and its shares cease to exist; hence, there is no subsisting property capable of sale or exchange. Further, "transfer" definition under Section 2(47) of the Act applies only to capital gains and not to

¹ M/s Jindal Equipment Leasing Consultancy Services Ltd, M/s Nalwa Investment Ltd, M/s Abhinandan Tradex Ltd, and M/s Mansarover Traded Ltd

stock-in-trade, and business income arises only upon actual realisation of stock-in-trade under Section 28 of the Act.

- Hypothetical or illusory benefits cannot be brought to tax as income. Mere receipt of shares pursuant to an amalgamation, even where the original shares were held as stock-in-trade, does not amount to a 'sale' or 'exchange' and therefore does not result in real income.
- Taxable business income accrues only when a real, enforceable right arises, not on hypothetical or notional appreciation. Any increase in the value of shares received on amalgamation is merely notional and becomes taxable only upon actual sale.
- The scheme of the Act supports this position, as notional or deemed income is taxed only where the legislature has expressly so provided. In the absence of any such deeming provision applicable to the Taxpayer's case, profit, if any, could be recognised only upon actual sale of the shares.

Revenue's contention:

- If the shares were held as stock-in-trade, any profit arising from receipt of shares of the amalgamated company would be taxable as business income. For the purpose of this issue, the Revenue assumed that the shares were held as stock-in-trade, though it remains factually to be decided by the Tribunal on remand.
- Business income is recognized when earned or realized, whether in cash or kind, irrespective of the mode of realization. Unlike Section 45 of the Act, transfer is not a prerequisite under Section 28 of the Act. Sections 28(i) and 28(iv) of the Act explicitly cover business profits and benefits, including those not convertible into money.
- Income accrues when the right to receive is acquired, even if actual receipt is later. The levy is not on hypothetical income and income accrues when it becomes due and there is a corresponding liability.
- Under the amalgamation scheme, the transferee company is liable to issue shares for extinguished shares, satisfying the real income test. Even if a 'sale' or 'transfer' is required, a scheme of amalgamation has 'all the trappings of a sale', and thus, the taxable event occurs.

- Relied on the decision in ***Orient Trading***², wherein the Supreme Court held that the exchange of securities by a share dealer amounted to realisation of stock-in-trade, resulting in taxable profits.

Supreme Court's observation:

Jurisdiction of the High Court

- The Supreme Court held that the High Court did not exceed its jurisdiction under Section 260A of the Act and observed that non-framing of a substantial question of law is not fatal where the issue is incidental to the Tribunal's findings and both parties had an opportunity to address it. The High Court only clarified the legal position and remanded the matter back to the Tribunal for factual determination. Accordingly, the High Court did not transgress its jurisdiction, and the Taxpayer's preliminary objection was rejected.

Scope of Section 28 of the Act – Profits and Gains from Business and Profession

- For chargeability under Section 28 of the Act, income must arise from or in the course of business, and either received or vested as a right and commercially realised, even if the receipt is in kind. Section 28 of the Act does not prescribe any specific mode through which profit must arise, nor does it incorporate the concept of 'transfer'.
- Expressions like 'business' and 'profits derived' in charging provisions are of wide import and must be construed broadly to give effect to the legislative intent and it cannot be cut down merely to avoid unusual or harsh consequences. Illustratively, waiver of a trading liability has been treated as taxable business income.
- Business profits may accrue or be realised in diverse circumstances, even in the absence of a conventional sale, transfer, or exchange in the strict legal sense. To confine the operation of Section 28 of the Act to such modes would unduly restrict a provision that has been intentionally couched in broad terms.
- Section 28 of the Act is a comprehensive charging provision designed to bring within the tax net all real profits and gains arising in the course of business, whether convertible into money or received in money or in kind, and irrespective of whether such accrual or

² (1997) 224 ITR 371 (SC): (1997) 3 SCC 340

receipt of income is accompanied by a legal transfer in the strict sense.

Amalgamation – Concept and Legal Character

- Amalgamation is a statutory blending of two or more undertakings, distinct from winding up, whereby the transferor company ceases to exist while its business, assets, and liabilities continue in the transferee company. It is thus a statutory substitution rather than a contractual transfer.
- The real issue is whether such statutory substitution of the shares gives rise to real commercial profits accrued in the course of business, so as to be taxable as business income.

Receipt/Accrual and Commercial Realisability upon Amalgamation

- Business income may be realised in kind; accordingly, receipt of shares of the amalgamated company in place of shares held as trading stock constitutes a receipt in kind.
- However, mere receipt is insufficient to attract taxability under Section 28 of the Act; commercial realisability is also essential when the income is received in kind. The decisive test is whether a real and presently realisable commercial profit has been obtained. To determine this, the Apex Court laid down a fact-based test:
 - the existing shares, being stock-in-trade, have ceased to exist;
 - the new shares have a definite and ascertainable value; and
- the Taxpayer can immediately dispose them off to realise money.
- If these conditions are met, the substitution constitutes commercial realisation and may be taxed under Section 28 of the Act. If not—such as where shares are subject to lock-in restrictions or are unlisted and illiquid—the allotment represents only a change in form of holding, yielding no taxable income at that stage; taxability is deferred until actual sale. The governing principle is that only real, realised or realisable income—not notional gains—can be taxed.
- The realisation is not a mere accounting exercise, but it occurs when the old asset is extinguished and replaced by a new asset of ascertainable value, enabling the profit or loss to be finally determined.

- Even where consideration takes the form of fully paid shares, a realised profit arises if the shares are realisable and capable of being converted into cash. The income embedded in commercial assets is deemed to be received when title passes, regardless of actual sale.
- Under a scheme of amalgamation, there is no real or completed profit capable of being taxed under Section 28 of the Act, unless it is shown that the shares are held as stock-in-trade and are readily available for realisation. Unless and until the substituted shares are commercially realisable – whether saleable, tradeable, or by whatever other mode of disposition so described – so as to yield real income, no taxable event can be said to arise.
- Well settled law is that for a profit to be taxable, it must be capable of definite valuation so that the real gain or loss stands crystallised; unrealised or notional gains are not taxable. Under the real income principle, which equally applies to stock-in-trade and other commercial receipts, “profits” in the commercial sense are ascertainable only when the earlier position is closed and the new position is determinable in money’s worth, whether through sale, transfer, exchange, or statutory substitution.
- Section 28 of the Act is attracted only where all the three conditions viz. actual receipt of shares, present commercial realisability, and ascertainability of value in money’s worth are satisfied. Where these attributes are absent, no hypothetical or notional income can be taxed. The determination is fact-sensitive, and the burden lies on the Revenue to establish that a real and presently realisable commercial benefit has arisen.

Timing of Taxability

- In cases of amalgamation, three distinct stages must be distinguished: the appointed date, the court’s sanction of the scheme, and the allotment of new shares. On the appointed date and upon court’s sanction, there is only a statutory substitution of rights, with no identifiable or tradable asset in the shareholder’s hands. Consequently, no taxable event arises at these stages.
- The charge under Section 28 of the Act crystallises only on the allotment of new shares, when the existing shares held as part of stock-in-trade are extinguished and replaced by new shares of the amalgamated company

- having a definite market value and capable of immediate realisation. Even if the scheme operates retrospectively from the appointed date, taxability is not triggered until actual allotment.
- The fact that market values may fluctuate thereafter does not make the gain hypothetical. For income-tax purposes, valuation is determined at a specific point in time. Once shares of determinable and presently realisable value are received in substitution of trading stock, a real commercial gain arises, resulting into taxable business income.

Distinction between Capital and Business Assets

- Section 47 of the Act grants an exemption for certain transfers arising from amalgamation, but this exemption is limited to capital assets. In contrast, Section 28 of the Act, which governs business income, contains no such exemption. Stock-in-trade is fundamentally different from an investment: it is circulating capital held for conversion into money in the ordinary course of business.
- Accordingly, the substitution of one trading asset by another—such as receiving shares of an amalgamated company in place of shares held as stock-in-trade—amounts to a commercial realisation in kind, as the new shares are distinct assets with definite and presently realisable value.
- While the Act expressly shields capital assets in amalgamation, it intentionally subjects business assets to tax under Section 28 of the Act, capturing real and presently realisable business profits arising from such substitutions.

Contributors

[Mehul Bheda \(Partner\)](#)

[Paras Sheth \(Principal\)](#)

[Sakshi Chawla \(Senior Associate\)](#)

[Nishi Doshi \(Senior Associate\)](#)

For any queries in relation to this tax alert, please feel free to reach out.

DHRUVA INSIGHT

The Supreme Court ruled that receipt of shares by the shareholders, pursuant to amalgamation, may be taxed as business income, if such shares are commercially realisable in money, of definite value in monetary terms, and the shareholder is in a position to freely dispose of or transfer such shares.

The present ruling marks a significant departure from the popular interpretation that receipt of shares pursuant to amalgamation is primarily tax-neutral for the shareholders, even where the shares are held as stock-in-trade by them.

While receipt of shares pursuant to amalgamation continues to be tax neutral where shares are held as capital assets, this decision has far-reaching implications where shares are held as stock-in-trade by shareholders.

The ruling introduces a fact-sensitive tests for receipt of assets in kind, including actual receipt, present commercial realisability, and ascertain ability of value and the Court has recognised that taxability may be deferred where these attributes are absent. The burden rests on the Revenue to establish a real and presently realisable commercial benefit.

Given the fact-intensive nature of the test, the decision is likely to increase litigation in cases involving shares held as stock-in-trade by the shareholders where the underlying company has undergone restructuring.

It will also be interesting to see the conclusion reached by the Tribunal in the present case on whether the shares were held as stock-in-trade or as capital assets by the Taxpayer, based on a factual analysis.

The ruling may raise interesting questions in the case of demergers, where on principles laid down by the Supreme Court, revenue may seek to levy tax where shares were held as part of stock in trade. In cases of a demerger, in addition to the shares of the demerged company, the shareholder will receive additional shares of the resulting company. The shares of the demerged company are not transferred and hence whether taxability can be defended will need to be considered. Further one may need to consider the characterisation of shares of resulting company received by the shareholders.

Taxation of the value of new shares upon allotment in lieu of existing shares held as part of stock in trade will only prepone the tax liability. The final gain or loss will arise upon the ultimate sale / transfer of the new shares and for such purposes the value considered at the time of allotment will be allowable as a cost.

ADDRESSES

Mumbai

Dhruva Advisors India Pvt. Ltd.
1101, One World Centre,
11th Floor, Tower 2B,
841, Senapati Bapat Marg,
Elphinstone Road (West),
Mumbai – 400 013
Tel: +91 22 6108 1000 / 1900

Ahmedabad

Dhruva Advisors India Pvt. Ltd.
402, 4th Floor, Venus Atlantis, 100 Feet
Road, Prahlad Nagar,
Ahmedabad – 380 015
Tel: +91 79 6134 3434

Bengaluru

Dhruva Advisors India Pvt. Ltd.
67/1B, Lavelle Road,
4th Cross, Bengaluru,
Karnataka – 560001
Tel: +91 90510 48715

Delhi / NCR

Dhruva Advisors India Pvt. Ltd.
305-307, Emaar Capital Tower-1,
MG Road, Sector 26, Gurugram
Haryana – 122 002
Tel: +91 124 668 7000

New Delhi

Dhruva Advisors India Pvt. Ltd.
1007-1008, 10th Floor, Kailash Building,
KG Marg, Connaught Place,
New Delhi – 110001
Tel: +91 11 4471 9513

GIFT City

Dhruva Advisor IFSC LLP
510, 5th Floor, Pragya II,
Zone-1, GIFT SEZ, GIFT City,
Gandhinagar – 382050, Gujarat.
Tel: +91 7878577277

Pune

Dhruva Advisors India Pvt. Ltd.
406, 4th Floor, Godrej Millennium,
Koregaon Park,
Pune - 411001,
Tel: +91 20 6730 1000

Kolkata

Dhruva Advisors India Pvt. Ltd.
4th Floor, Camac Square,
Unit No. 403 & 404B,
Camac Street,
Kolkata - 700016, West Bengal
Tel: +91-33-66371000

Singapore

Dhruva Advisors Pte. Ltd.
#16-04, 20 Collyer Quay,
Singapore – 049 319
Tel: +65 9144 6415

Abu Dhabi

Dhruva Consultants
1905 Addax Tower,
City of Lights, Al Reem Island,
Abu Dhabi, UAE
Tel: +971 26780054

Dubai

Dhruva Consultants
Emaar Square Building 4,
2nd Floor, Office 207, Downtown,
Dubai, UAE
Tel: +971 4 240 8477

Saudi Arabia

Dhruva Consultants
308, 7775 King Fahd Rd,
Al Olaya, 2970,
Riyadh 12212, Saudi Arabia

KEY CONTACTS

Dinesh Kanabar

Chairman & CEO
dinesh.kanabar@dhruvaadvisors.com

Punit Shah (Mumbai)

Partner
punit.shah@dhruvaadvisors.com

Mehul Bheda (Ahmedabad/ GIFT City)

Partner
mehul.bheda@dhruvaadvisors.com

Aditya Hans (Bengaluru/ Kolkata)

Partner
aditya.hans@dhruvaadvisors.com

Vaibhav Gupta (Delhi/ NCR)

Partner
vaibhav.gupta@dhruvaadvisors.com

Sandeep Bhalla (Pune)

Partner
sandeep.bhalla@dhruvaadvisors.com

Nimish Goel (Middle East)

Leader, Middle East
nimish.goel@dhruvaadvisors.com

Dilpreet Singh Obhan (Singapore)

Partner
dilpreet.singh@dhruvaadvisors.com

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