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CASE NOTE: *THE COMMISSIONER OF INCOME TAX* V. *M/S NALWA INVESTMENTS LTD AND OTHERS*

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Abstract The taxation of capital gains has involved some interesting conceptual puzzles that have centred around the idea of a *transfer* of a capital asset. The Delhi High Court decision in *CIT* v. *Nalwa Investment Ltd.*[1] ('*Nalwa Investment*') is an example of a line of cases concerned with the definition of transfer in the context of an amalgamation. *Nalwa Investments* demonstrates the continuing importance of the Supreme Court decision on the definition of *transfer* in *CIT* v. *Grace Collis*.[2] Further, *Nalwa Investments* is also important for the application of the scheduler system of taxation, with important consequences for the manner in which an item of income is taxed under the Indian Income Tax Act, 1961.

I. INTRODUCTION

The taxation of capital gains in India has always had the tendency to generate some conceptual puzzles that have piqued tax lawyers and tax academics. The Delhi High Court's decision in *CIT* v. *Nalwa Investments Ltd*[3] ('*Nalwa Investments*') is an example of something rare and intriguing — a chance to revisit one of the most interesting cases in capital gains while also demonstrating the application of an important principle of Indian tax law: the scheduler system of taxation. This case note will outline the basic principles of capital gains and the scheduler system of taxation relevant to a discussion of *Nalwa Investments*, followed by an analysis of the case.

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[1] (2020) 427 ITR 229.

[2] (2001) 3 SCC 430.

[3] (2020) 427 ITR 229.

II. CAPITAL GAINS AND THE SCHEDULER SYSTEM OF TAXATION

The most striking part of capital gains taxation is its incongruous position in the scheme of the Income Tax Act, 1961 ('the ITA'). It is not an item of income as normally understood in income tax law and has been shoehorned into the definition of income by making a specific provision for it.[4] Further, the taxation of capital gains is covered under a separate schedule in the ITA. The scheduler character of taxation is a well-known feature of the ITA. In a scheduler system, as opposed to a global system of taxation, items of income are pigeonholed into various categories. The ITA imposes a tax on income and then proceeds to calculate the tax payable under various schedules or headings. There are five such schedules in the ITA, respectively titled Salaries, Income from House Property, Profits and Gains of Business or Profession, Capital Gains, and finally, Income from Other Sources.

Tax is calculated under each of these headings by including a charging section, and then allowing various deductions and exemptions that are particular to each heading of income. Thus, the tax payable by a person on any item of income will depend on the schedule in which the item of income is classified. The revenue's task is not merely to charge a taxpayer for income tax but to charge a taxpayer under a particular schedule. In some instances, this works to the advantage of the revenue if an item of income falls within a schedule in which the tax calculation might result in a larger tax than would be the case if some other schedule was in play. On the other hand, as it happens every so often, it is the taxpayer who is advantaged when the item of income for which he is charged falls within a schedule that exempts his income or provides for a generous deduction. Following the *Salisbury* principle, if an item of income escapes taxation under a particular schedule or is not taxed to the fullest extent possible, the revenue cannot bring the same item to tax under another schedule.[5] Characterisation of an income therefore remains critical for the application of the scheduler system of taxation.

As mentioned above, 'capital gains' is one of the schedules of income in the ITA. Under section 45, the charging section in the capital gains schedule, any profit or gain arising from the transfer of a capital asset will be subject to taxation. Transfer is defined in a very broad manner in section 2(47) of the ITA, as inclusive of a sale, exchange or 'extinguishment of any rights' in an asset. The reference to extinguishment shows that the concept of a transfer in the ITA has trespassed into areas beyond the conventional meaning of the word. Section 47 of the ITA deems certain kinds of transfers as exempted from the capital gains charge under section 45. Well known examples of such exemptions

4 Income Tax Act 1961, s 2(24)(vi).

5 *Fry v Salisbury House Estate Ltd* [1930] AC 432.

are property undergoing a change in ownership under a will or a gift deed.[6] Another example of a section 47 exemption, which is also the subject matter of this case comment, is an amalgamation transaction, which is discussed below. Under section 48, 'capital gains' is calculated by way of a simple formula: the money received for the transfer of an asset (called the consideration) is reduced by the cost of acquisition of the transferred asset in the hands of the transferor.

III. TAXATION OF AMALGAMATIONS

The ITA defines an amalgamation as a transaction in which one company's assets and liabilities are transferred to another company, with the company that transferred its assets (and liabilities) going out of existence and at least three fourths of its shareholders (by value) receiving shares in the company to which the assets (and liabilities) were transferred.[7] There are two potential trigger points for capital gains in this situation. One, a company level capital gain is potentially triggered when assets (and liabilities) are transferred from one company (called the amalgamating company) to another (called the amalgamated company). Further, a shareholder level capital gain is potentially triggered when the shareholders of the amalgamating company receive shares in the amalgamated company in exchange for their shares in the amalgamating company. Section 47 of the ITA exempts both these potential trigger points from capital gains taxation.[8]

Section 49(2) of the ITA captures the untaxed shareholder level gains in an amalgamation at a subsequent time when the shares received in the amalgamation are transferred again. This section provides that when a person receives shares in an amalgamation exempted under section 47(vii) of the ITA, his cost of acquisition of the amalgamated company's shares is deemed to be the price at which he had acquired his shares in the amalgamating company, thus preserving the taxable gain at the time of amalgamation, which is then captured subsequently at the time he sells the shares of the amalgamated company. Thus Section 49(2) of the ITA establishes a carry-over basis for a person's shares in the amalgamated company, that is, the cost of his shares in the amalgamating company carries over to the cost of his shares in the amalgamated company.

Some shareholders continue to insist that amalgamations are not transfers at all in the first place. Section 47 is curiously worded. It's heading and its opening line contradict each other. The heading states: "Transactions not regarded as transfer". However, section 47 begins with the following line: "Nothing contained in section 45 shall apply to the following transfers". Normally the

6 Income Tax Act 1961, s 47(iii).

7 Income Tax Act 1961, s 2(1B).

8 S 47(vi) exempts any potential company level capital gain in an amalgamation and s 47(vii) exempts any potential shareholder level capital gain in an amalgamation.

heading should not trump the plain meaning of the clause itself.[9] I believe that it is uncontroversial that section 47 is not meant to deny the status of transfer to certain transactions, but rather places certain transactions, even if they fulfill the definition of transfer, beyond the pale of section 45.

Nevertheless, it is also plain that section 47 exempts certain transactions that would not result in capital gains in any case. Both wills and gifts would not be subject to capital gains under section 45 as the transferor does not receive any consideration in either of these two cases. In an amalgamation, there appears to be no capital gains issue at the company level when the amalgamating company transfers its property to the amalgamated company as the amalgamating company does not receive any consideration in return.[10] Yet, section 47(vi) exempts company level capital gains. The capital gains issue at the shareholder level is more complex. Here, there is a potential capital gain because the amalgamated company's shares might have a higher market value, compared to the amalgamating company's shares. Therefore, section 47(vii) might be helpful in preventing capital gains at the shareholder level.

IV. *GRACE COLLIS* AND *VANIA SILK MILLS*

However, even at the shareholder level, the shareholders have argued that section 47(vii) is inoperative as there is no transfer in the first place. This was the argument used by the shareholders in the Supreme Court in *CIT* v. *Grace Collis*,[11] which dealt with the tax consequences of an amalgamation. If the shares in the amalgamated company were not received by virtue of a transfer, section 49(2), which applies only to transfers exempted under section 47(vii), will not be applicable in calculating the cost of the amalgamated company's shares in the hands of the shareholders of the amalgamating company. Consequently, as there would be no guidance in the ITA on the costing method to be applied with respect to these shares, the capital gains charge on a subsequent sale of the amalgamated company's shares would fail because of the failure of the costing calculation.[12]

The shareholders in *Grace Collis* were banking on the idea that an amalgamation was not a transfer as there were no sale or exchange of shares

[9] The Supreme Court, in *Frick India Ltd v Union of India* (1990) 1 SCC 400, while interpreting a tariff schedule, held, in para 7, the following:

> It is well settled that the headings prefixed to sections or entries cannot control the plain words of the provision; they cannot also be referred to for the purpose of construing the provision when the words used in the provision are clear and unambiguous; nor can they be used for cutting down the plain meaning of the words in the provision.

[10] There might be a capital gain issue if liabilities in excess of assets are transferred by the company.

[11] (2001) 3 SCC 430.

[12] The Supreme Court has held, in *CIT v BC Srinivasa Shetty* (1981) 2 SCC 460: (1981) 128 ITR 294, that if it is not possible to calculate the capital gains in any particular instance, the capital gains charge would fail entirely.

in an amalgamation. An earlier Supreme Court decision in *CIT* v. *Rasiklal Maneklal*[13] ('*Rasiklal*') had held that there was no sale or exchange of shares in an amalgamation because the amalgamating company shares were only a 'qualifying condition' for the shares in the amalgamated company to be received pursuant to a court order.[14] However, *Rasiklal* was decided in the context of the Income Tax Act, 1922, in which the definition of transfer did not include the extinguishment of rights in an asset. The ITA, 1961, added extinguishment of rights in an asset to the definition of a transfer. The Supreme Court decided in *Grace Collis*, that under the current law, an amalgamation will result in a transfer of the shares of the amalgamating company, because the rights of the shareholders in their shares were 'extinguished' in the amalgamation.[15]

Previously, in *Vania Silk Mills (P) Ltd* v. *CIT*,[16] ('*Vania*') the Supreme Court had adopted a different approach to the definition of transfer while deciding on the capital gains consequences of money received under an insurance contract. The insurance payout was for the destruction of property in a fire. When the property was destroyed, the rights of the owners in the property were extinguished. The revenue argued that any money received under the insurance contract was due to the transfer of property and therefore subject to capital gains.

In *Vania*, the Supreme Court stated that for a transfer to take place for capital gains purposes, the asset that was the subject matter of transfer had to survive the transfer. Therefore, if the asset itself went out of existence in a particular transaction or as a result of a particular event (for example, a fire), there would not be a transfer for capital gains purposes even though all the rights in the asset had been extinguished.[17] *Vania* was important for the reason that it held that every case of extinguishment would not amount to transfer. In *Grace Collis*, the Supreme Court overruled *Vania* to the extent that extinguishment of rights in an asset would ipso facto be considered as a transfer for capital gains purposes. It is in the background of this law that *Nalwa Investments* came up for consideration in the Delhi High Court.

V. THE DECISION IN *NALWA INVESTMENTS*

Nalwa Investments was a straightforward case of amalgamation in which one company amalgamated into another followed by the shareholders of the amalgamating company receiving shares in the amalgamated company. The only wrinkle was that the assessing officer believed that the amalgamating company's shareholders held their shares not as an investment but as trading stock. If a person holds property as a trading stock, then any income realised

[13] (1989) 2 SCC 545.
[14] *See*, discussion of *Rasiklal* in *Grace Collis* (2001) 3 SCC 430, para 11.
[15] (2001) 3 SCC 430, para 18.
[16] (1991) 4 SCC 22.
[17] *See*, ibid paras 3,4 and 5 for the Supreme Court's analysis of transfer.

from the trading stock would be considered as business income, not capital gains. The assessing officer concluded that the income in issue in this case was trading income and not capital gains as the amalgamating company's shareholders, in the opinion of the assessing officer, held their shares as trading stock.

In a peculiar approach to the application of tax law, the Income Tax Appellate Tribunal ('ITAT') decided that the question of whether there is income or capital gains, was not the right question to ask. In fact, the ITAT considered this issue as irrelevant. The relevant question was whether there was a 'profit' made in the amalgamation. The ITAT concluded:

> In our opinion, no profit accrues unless the shares held by an assessee are either sold or transferred otherwise for consideration irrespective of the nature of holding.[18]

When this case reached the Delhi High Court, the court decided that the question of whether the category of income was capital gains or business income, was a question of primary importance, because only a resolution to this question would enable the court to determine the tax issues that arose from the amalgamation.[19] Why did the ITAT believe that this question was irrelevant? There are two possible explanations for the ITAT's decision. The most straightforward explanation is that it went wrong in its understanding of the consequences of a scheduler system of taxation. Without identifying the schedule to which a particular source of income belongs, it is not possible to further inquire into the taxability of the income.

Alternatively, perhaps the ITAT believed that if there were no 'transfer' of property, there would no accretion to wealth that would qualify as income for purposes of the ITA. However, there is no statutory basis for this approach towards the definition of income in the ITA. The definition of income is an inclusive one and does not create an exception for property transactions that do not amount to a transfer. The concept of a transfer in fact is peculiar to the capital gains schedule and impacts the taxability of capital gains. The Delhi High Court discussed a Supreme Court case to buttress this point.

The Delhi Court's point of reference was the well-known Supreme Court decision in *Orient Trading Co. Ltd.* v. *CIT*[20] ('*Orient Trading*'). In *Orient Trading*, the Supreme Court was concerned with a 'share for share' exchange between two companies. The first company's shareholders gave their shares to the second company in return for the second company issuing its shares to the first company's shareholders. The first company's shareholders held their shares

[18] ITAT ruling, quoted in *Nalwa Investment* (2020) 427 ITR 229, para 14.

[19] ibid para 29.

[20] (1997) 3 SCC 340: (1997) 224 ITR 371.

of the company as trading stock. The Supreme Court decided that there was a realisation of business income for the purposes of the ITA calculated as the difference between the market price of the second company's shares and the cost price of the first company's shares in the hands of its shareholders. The Supreme Court ignored any issue relating to transfer in this case as it was not concerned with the capital gains schedule.

The Delhi Court in *Nalwa Investments* also decided that if the amalgamation were to raise an issue of capital gains, the share for share exchange in the amalgamation would result in a transfer, albeit a transfer that would be exempted under section 47. The ITAT had relied on *CIT* v. *Rasiklal Maneklal* ('*Rasiklal*') to hold that there was no transfer in an amalgamation. However, as noted earlier, the Supreme Court in *Grace Collis* had held that *Rasiklal* would not apply in the current scenario because it was decided in the context of the Income Tax Act, 1922, in which the definition of transfer did not include the extinguishment of rights in an asset. Following *Grace Collis,* the Delhi High Court accepted the point that there was a transfer in a 'share for share' exchange in an amalgamation.[21] The Delhi High Court remanded the case back to the ITAT for a determination on the following question: whether the shares were held as investments or as trading stock?[22] Thankfully this issue is not as thorny as before because the revenue has issued detailed guidelines in a circular on this point.[23]

VI. CONCLUSION

The *Nalwa Investments* case underlines the importance of the scheduler system of taxation in India. It is important to remember that virtually every tax dispute of any substance is concerned with issues *within* one of the five schedules in the ITA rather than *across* the schedules. There used to be a time when the status of a receipt as a capital receipt or income was important, and this distinction was important without regard to the scheduler system because it was concerned with the definition of income for purposes of the ITA. However, with the definition of income being amended to include capital gains and a variety of other accretions to wealth, these distinctions have faded away.[24] Even distinctions that appear to be free of a scheduler influence, for example the distinction between capital and revenue expenditure, are actually debates that are relevant within one particular schedule, in this case the schedule concerned with business income. The ITAT tried to impose a supra schedule test

21 *Nalwa Investment* (2020) 427 ITR 229 para 25.

22 ibid para 31 read with para 15.

23 Circular No 6/2016 [F No 225/12/2016-ITA-II], Dated 29-2- 2016.

24 For example, *see*, s 2(24)(xii), which deems any sum referred to in clause (va) of s 28 as income. S 28(va) refers to, inter alia, any sum received under an agreement for *not* carrying out any activity in relation to any business or profession.

of transfer to the facts. This approach was misguided, as the idea of a transfer gains currency only within the capital gains schedule.

The ITAT's view on transfer cannot find ground, as the Delhi High Court rightly decided, even within the confines of the capital gains schedule, because of the Supreme Court decision in *Grace Collis.* Normally, a transfer of an asset does not include a situation where the asset that is the subject matter of the supposed transfer is extinguished, but the definition of transfer in section 2(47) appears to consider extinguishment as an independent mode of a transfer, in addition to the other modes mentioned in the definition, namely a sale, a purchase, an exchange, or arelinquishment. The Supreme Court in *Grace Collis* held that an extinguishment of an asset can be a transfer by virtue of the extinguishment itself, thus overruling its previous ruling in *Vania Silk Mills.*

While the Delhi High Court was bound by *Grace Collis*, *Nalwa Investments* was also an opportune moment for the Court to test the application of the sweeping retrospective amendment made to the section 2(47) definition of transfer in 2012 as a response to the Supreme Court's decision in *Vodafone International Holdings BV* v. *Union of India*.[25] The 2012 amendment adds an explanation to section 2(47) that reads:

> For the removal of doubts, it is hereby clarified that "transfer" includes and shall be deemed to have always included disposing of or parting with an asset or any interest therein, or creating any interest in any asset in any manner whatsoever, directly or indirectly, absolutely or conditionally, voluntarily or involuntarily, by way of an agreement (whether entered into in India or outside India) or otherwise, notwithstanding that such transfer of rights has been characterised as being effected or dependent upon or flowing from the transfer of a share or shares of a company registered or incorporated outside India.

The last part of the explanation suggests that it is meant to address transfers of shares with an overseas connection, but the text of the explanation is capacious enough to include transactions with no overseas aspects. It could be argued plausibly that in an amalgamation, an interest in the amalgamated company is created, albeit indirectly, and therefore there is a transfer for income tax purposes. However, because of the *Grace Collis* decision, the Delhi High Court did not go into the question of the application of the explanation. If it had, it might have found that the explanation has joined hands with *Grace Collis* in settling the issue of transfer in an amalgamation in favour of the revenue.

[25] (2012) 6 SCC 613.