Capital Gain – On Transfer of Share as an Offer For Sale Under IPO Process

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1. **Background**

Finance Act 2018 brought a paradigm shift in taxation of long-term capital gain arising from the transfer of equity shares as it withdrew the exemption on long-term capital gains arising on transfer of equity shares. With the withdrawal of the exemption, specific provision in the form of section 112A of the Income Tax Act, 1961 ('Act') was inserted to tax long-term capital gains. Further, clause (ac) to sub-section (2) to section 55 of the Act was inserted to provide a special mechanism for computation of cost of acquisition in respect of assets covered under section 112A of the Act and acquired prior to 01 February 2018.

An explanation to afore-mentioned clause (ac) has also been inserted, wherein an exhaustive definition of fair market value is provided, which is imperative to know to arrive at the cost of acquisition of long-term capital assets.

In the above backdrop, a question remains, on how to compute the cost of acquisition of equity shares which were unlisted and acquired before 01 February 2018 and such shares are transferred as an Offer For Sale ('OFS') being part of Initial Public Offer ('IPO') process i.e. before listing of such shares on a recognized stock exchange.

To illustrate the above, an individual, who is a promotor in an unlisted company and has subscribed equity shares before 01 April 2018 @ INR 100 per share. Now, such an individual is contemplating to transfer the share in the year 2023 @ 1,000 per share under the IPO process as an OFS.

2. **Law in relation to computing the long-term capital gain and tax liability thereon in view of the transaction under consideration**

Undoubtedly, since the provisions of section 55(2)(ac) of the Act comes into the picture, where the conditions of section 112A are satisfied first, hence let's analyse hereunder whether the ingredients of section 112A of the Act are satisfied in the above illustration:

1. Equity shares under consideration are held for more than 24 months and hence qualify as long-term capital assets, accordingly, income from transfer of shares would qualify as income

chargeable under the head “Capital Gains”;
2. Since the shares are unlisted at the time of subscription/acquisition and hence, the payment of security transaction tax was not required at the time of acquisition in view of the CBDT notification No. 60/2018 dated 01 October 2018;
3. Though the shares are unlisted at the time of transfer also, however the payment of security transaction tax is required to be made in view of section 98 read with section 97(13)(aa) of the Finance (No. 2) Act, 2004.

Since, the conditions of section 112A are satisfied and shares are acquired before 01 February 2018, the cost of acquisition is to be determined in pursuant to section 55(2)(ac) of the Act.

On a plain reading of provisions of section 55(2)(ac) of the Act, it is clear that to determine the cost of acquisition, the following components should be identified:

- Actual cost of acquisition of the shares, which is INR 100 (as illustrated above);
- Fair market value as on 31 January 2018, which is to be evaluated as per clause (a) to explanation to section 55(2)(ac) of the Act;
- Full value of consideration on transfer of shares, which is INR 1,000 (as illustrated above).

The term fair market value as defined as an explanation to section 55(2)(ac) of the Act has got 3 limbs, discussed as under –

- Sub-clause (i) considers a scenario where shares are listed on a recognised stock exchange on 31 January 2018. Since, in our illustration, the equity shares are not listed on 31 January 2018, hence fair market value in accordance with clause (i) cannot be computed.
- Sub-clause (ii) refers to fair market value of units. Since, the capital assets under consideration is equity shares, but not units, and hence not applicable for our specific case illustrated above.
- Sub-clause (iii) refers to fair market value of equity shares, which are listed on the date of transfer. Since, in our illustration equity shares are transferred under OFS as part of IPO process, the same are unlisted on the date of transfer, hence fair market value in accordance with clause (iii) also cannot be computed.

In absence of such formula determining ‘fair market value’ as on 31 January 2018, one view suggests that no capital gains would be payable as the computation mechanism fails. However, it may not be a correct view as the purpose of insertion of sections 112A and 55(2)(ac) of Act was not to exempt the capital gains income but to grandfather the gains up to 31 January 2018 and tax balance capital gains.

On the contrary, another school of thought could be to consider that computation of capital gains mechanism fails and accordingly, the individual promoter is not liable to discharge his capital gain tax liability.

3. **Golden Principles of Statutory Interpretation and Judiciary Views**

In context to the above, we recall the golden principals of statutory interpretation called as “Language of the Statute Should be Read as it is”. Meaning thereby, the intention of the Legislature is primarily to be gathered from the language used, which means that ***attention should be paid to what has been said as also to what has not been said.*** As a consequence, a construction which requires for its support addition or substitution of words or which results in rejection of words as meaningless has to be avoided. In this context, in the case of A V. Fernandez v. State of Kerala [1957 SCR 837], a constitution bench of the Hon’ble Supreme Court discussed how tax laws should ordinarily be construed:

“29. It is no doubt, true that in construing fiscal statutes and in determining the liability of a subject to tax one must have regard to the strict letter of the law and not merely to the spirit of the statute or the substance of the law. If the Revenue satisfies the Court that the case falls strictly within the provisions of the law, the subject can be taxed. If, on the other hand, the case is not covered within the four corners of the provisions of the taxing statute, no tax can be imposed by inference or by analogy or by trying to probe into the intentions of the legislature and by considering what was the substance of the matter”.

Applying the ratio of the above decision, where the case to compute the fair market value does not fall

under any of the sub-clause, then to expand or alter the scope of any of the sub-clause should not be accepted. Accordingly, where the computation of fair market value cannot be identified, then cost of acquisition of equity shares may not be determinable and hence computation mechanism fails. This view is also supported by decision of Hon'ble Supreme Court in the case of CIT vs B C Srinivasa Setty [1981] 128 ITR 294 (SC) [TS-2-SC-1981-O].

4. **Conclusion**

In view of the above and considering that going for IPO is in vogue in last 1-2 years, it becomes a mindful exercise to evaluate the capital gain tax implications, where the equity shares are offloaded by the promotors as part of IPO process under OFS. Though, the above cited judicial pronouncement may be sheltered to take an aggressive view, a better view could be that fair market value determined by a professional valuer as on 31 January 2018 be treated as the cost of acquisition for the shares to be sold under OFS, until clarity is provided by way of an amended to section 55(2)(ac) of the Act.

* *views expressed are personal & may not reflect that of the organisation.*