

Liquidation of Companies: Understanding the Tax Consequences

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Evolution of various macro and micro economic and business factors, increased regulatory scrutiny, surge of new age business, tax transparency, etc. have changed the mode of doing businesses and the manner in which business groups are structured. As a result, it has now become a norm that, fewer the business entities, the better it is.

Therefore, for various reasons, such as completion of a project, unsuccessful business venture, etc., there may be a need to shut down a company. The company laws in India enable a company closure through various means, such as merger, strike off of a company, winding up, liquidation, etc.

As a result, winding up such companies becomes essential. Liquidation is one of the ways to achieve this.

Concept of liquidation

Liquidation is the process of systematic winding up of a company, sale of its assets and payment of its debts under the Insolvency and Bankruptcy Code, 2016 ('IBC'). Liquidation can be in the form of voluntary liquidation, initiated by the company's Directors or shareholders, or a compulsory liquidation, initiated by the creditors, and ordered through a Court process.

Usually in case of liquidation, sale proceeds of assets (post payment of debts) are distributed to the company's shareholders. However, there are various instances where an in-specie distribution of assets of the company is made to the shareholders. Following are certain precedents of the same:

1. Order of the National Company Law Tribunal ('NCLT'), Mumbai bench, in Sprint Advisory Services Private Limited - The NCLT approved voluntary liquidation of the company u/s 59 of the IBC. Pursuant to the liquidation, investments of the company in shares of M/s. Future Generali India Life Insurance Company Limited (FGLIC) were distributed to the shareholders of the company.
2. Order of NCLT, Mumbai bench, in Saket City Hospitals Limited ('SCHL') - Prior to liquidation, Max Healthcare Institute Limited ('Max Healthcare') had acquired 100% shares in SCHL. Thereafter on liquidation of SCHL, the operations of SCHL were consolidated with that of Max Healthcare, to unleash operational efficiencies and other synergies, by way of distribution of the entire business undertaking of SCHL to Max Healthcare on a going concern basis.

Tax implications on liquidation

The tax implications of liquidation are crucial for shareholders. According to the Income-tax Act, 1961 (IT Act), consideration received by shareholders on liquidation is taxed as dividend under Section 2(22)(c). This tax is applicable to the extent the liquidating company has accumulated profits immediately before the liquidation.

Distribution made by a company to its shareholders shall not be regarded as a transfer in the hands of company. Consequently, this distribution will not be subject to capital gains tax for the company, as per Section 46(1) of the IT Act.

However, the balance consideration received by shareholders, net of consideration taxed as dividend, will be chargeable to capital gains for the shareholder. This capital gain will be calculated on the money received from the company or the market value of the other assets on the date of distribution, as per Section 46(2) of the IT Act.

In essence, any consideration received by shareholders of a company on its liquidation, whether as cash or by way of assets distributed from the company, are subject to tax in the hands of shareholders (i.e. either as dividend or capital gains).

Cost of acquisition of assets received by shareholders on liquidation

Once assets of a company are received by its shareholders on liquidation, such assets become the property of the shareholder. Consequently, these assets can be disposed off by the shareholder. Therefore, analyzing the cost of acquisition of such assets in the hands of the shareholders becomes essential.

The IT Act provides two provisions for determining the cost of acquisition of assets received by shareholders on liquidation.

According to Section 49(1)(iii)(c), where a capital asset becomes the property of a shareholder on distribution of assets by a company on its liquidation, the cost of acquisition of the asset shall be deemed to be the cost for which the previous owner of the property (i.e., the company) acquired it.

In other words, as per Section 49(1)(iii)(c), the cost of acquisition of assets received by a shareholder shall be equal to the cost of acquisition of the assets for the liquidating company.

Furthermore, as per Explanation 1 to Section 2(42A) of the IT Act, the period of holding of such assets for the shareholders will also include the period for which the liquidating company held the assets.

Furthermore, Section 55(2)(b)(ii) of the IT Act provides that where a capital asset becomes the property of a shareholder on distribution of capital assets of a company on its liquidation, and the shareholder has been assessed to income-tax under the head 'capital gains' in respect of that asset under Section 46, then the cost of acquisition of such assets shall be the fair market value of the asset on the date of distribution.

In this scenario, the period of holding of such asset will be determined from the date of distribution.

Therefore, the income tax laws provide two separate provisions for determination of cost of acquisition of assets received by shareholders on liquidation of a company, and therefore, it is important to analyse which provision of the IT Act should be referred to.

Notably, Section 55(2)(b)(iii) provides a specific condition that the shareholder should be assessed to capital gains tax on the assets received on liquidation.

As per the opening expression of Section 46(2), receipt of assets by a shareholder on liquidation will be subject to capital gains (post deducting amount considered as dividend u/s 2(22)(c)). Therefore, capital gains will have to be tested in the scenario, even if the outcome results in a capital loss situation for the shareholder.

This becomes specifically relevant in a situation where the entire consideration being paid to shareholders by the liquidating company is taxed as dividend under Section 2(22)(c). Merely because as per Section 46(2) the amount of distribution taxed under section 2(22)(c) has to be deducted from the full value of the distribution on liquidation for the purpose of computation of capital gains, should not mean that if the accumulated profits are more than the total distribution on liquidation (money distributed + market value of asset distributed), no computation should be made under the head 'capital gains'. The words used in Section 46(2) of the IT Act are "*he shall be chargeable to income-tax under the head 'Capital gains'*", and a plain reading of the same does not indicate that necessarily there should be positive capital gain only.

This can be explained with the help of below illustration:

Company A (liquidated company) made investment in shares of company B and cost of acquisition for such shares is INR 10,000.

On account of liquidation, liquidated company has distributed following assets to the shareholder.

- a. Shares of company B (FMV on the date of distribution to shareholders - INR 15,000)
- b. Land and Building (FMV- INR 50,000)

Shareholders' cost of acquisition of shares in liquidated company - INR 5,000

Sale of company B shares by the shareholder - INR 100,000

Accumulated profits in liquidated company immediately before liquidation - INR 15,000

Following should be the tax implications in this case:

Particulars	Amount in INR
Total assets (A)	65,000
Accumulated profits (B)	15,000
Full value of consideration for the purpose of section 48 (A) - (B)	50,000
Less: Cost of acquisition of shares in company A	(5000)
Capital gains	45,000

In this case, for the purpose of computing capital gains on account of sale of shares of Company B by the shareholder, the cost of acquisition should be INR 15,000 in terms of Section 55(2)(b)(iii), since the shareholder has been assessed to capital gains on liquidation.

In an identical scenario, if the accumulated profits in the books of Company A immediately before liquidation were INR 65,000, the entire FMV of the assets distributed on liquidation would have been taxed as dividend. However, provisions of Section 46(2) are still being tested in such a scenario, and therefore, the cost of acquisition of shares of Company B in this case will be INR 15,000.

In this regard, it is also relevant to note that section 46A of the Act, which deals with capital gain on share buy-back, pursuant to insertion of section 2(22)(f) by the Finance (No.2) Act, 2024, a proviso has been inserted in section 46A to ensure that the cost of acquisition does not go waste in the hands of the shareholders.

A logical and harmonious interpretation should be that where the entire value (money received + FMV of assets received by the shareholders upon liquidation) is taxed under section 2(22)(c), the cost of acquisition of the shares of the company in liquidation should not go to waste and the shareholder should be allowed a loss under the head capital gain even under the specific provision of section 46(2).

Analysis and conclusion

A logical interpretation of the tax provisions suggests that Section 55(2)(b)(iii) is applicable in the context

of liquidation. This provision ensures that the cost of acquisition of assets received by shareholders is determined based on the fair market value of the asset on the date of distribution.

In conclusion, the tax implications of liquidation are complex and require careful consideration. Shareholders must understand the tax implications of receiving consideration on liquidation, including dividend and capital gains, particularly if the consideration is received in-specie. Furthermore, determining the cost of acquisition of assets received by shareholders is crucial, and the IT Act provides two contrasting provisions in this regard.