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Issue of fresh equity shares is not a transfer of capital asset and therefore not taxable under the Income-tax Act

Background

Recently, the Mumbai Bench of the Income-tax Appellate Tribunal (the Tribunal) in the case of Supermax Personal Care Private Limited[1] (the taxpayer) held that issue of fresh equity shares is not a transfer of capital asset. It is a capital receipt and therefore not taxable under the Income-tax Act, 1961 (the Act). The Tribunal observed that in order to attract the capital gain tax under Section 45 of the Act, the property transferred must be a capital asset on the date of transfer. However, in taxpayer's case, there was no transfer of a capital asset.

The Tribunal observed that Explanation[2] to Section 2(47) of the Act was introduced in the year 2013, whereby the concept of 'creating of interest in any assets in any manner' was added. However, in the instant case, the transaction was undertaken prior to 2013, hence it was not applicable to the instant case. Further, indirect transfer related provisions[3] cover non-residents and not residents; therefore, these provisions are not applicable to the taxpayer.

Facts of the case

- The taxpayer is engaged in the business of manufacturing and selling of shaving products and systems. On 30 December 2010, the taxpayer entered into two Business Transfer Agreements (BTA), with RCC Sales Pvt. Ltd. (RCC) and Vidyut Metallics Pvt. Ltd. (VMPL) for the acquisition of business operations of said companies on a slump sale basis for a consideration of INR273 million and INR1105 million respectively.

- On 30 March 2011, the taxpayer issued 37,600 fresh equity shares at INR39,500 per share to Super Max Singapore Pte. Limited (SSPL) which is the 99.99 per cent shareholder of the taxpayer. Thus, there was an infusion of the share capital of INR1485 million.

- Super Max Offshore Holdings (SMOH), Cayman Islands, is investment holding company for the group companies encompassing a number of operating companies outside India including the taxpayer. SMOH was an ultimate shareholder of Super Max group of companies. During the year, SMOH issued fresh shares, and Actis Consumer Grooming Products Ltd., Mauritius (Actis) subscribed to 29.17 per cent of the said shares for INR10025 million. However, the remaining 70.83 per cent stake was transferred to Super Max Mauritius. The sale of stock to Actis was to be taken as the basis of valuing the stake of remaining 70.83 per cent shares.

- The taxpayer claimed that it had neither issued any shares to Actis nor had any other dealings with Actis. Further, it had neither received any payment from Actis nor had transferred any assets during the year.

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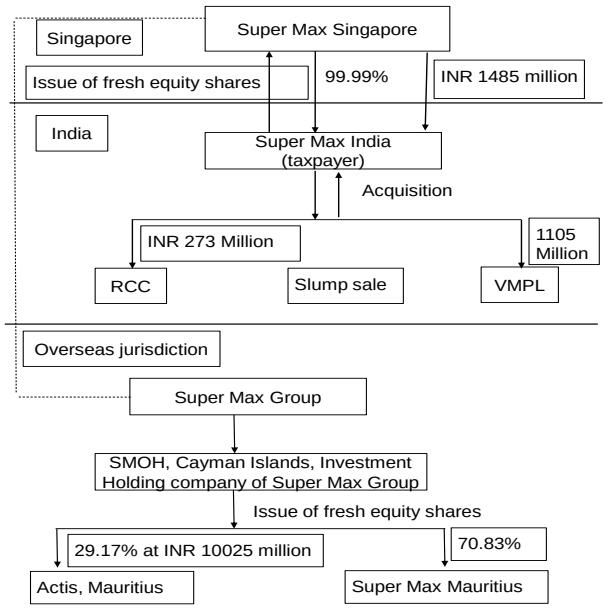
[1] Supermax Personal Care Private Limited v. ACIT (ITA No. 6107/Mum/2016) – Taxsutra.com

[2] Explanation 2 to Section 2(47) of the Act provides 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 characterized as being effected or dependent upon or flowing from the transfer of a share or shares of a company registered or incorporated outside India.

[3] Explanation 5 of Section 9 of the Act - An asset or capital asset being any share or interest in a company or entity registered or incorporated outside India shall be deemed to be and shall always be deemed to have been situated in India, if the share or interest derives, directly or indirectly, its value substantially from the assets located in India

- The transaction is depicted as follows:



- The Assessing Officer (AO) held that the taxpayer transferred the stake outside India to SSPL at INR1485 million. However, the actual value of transfer of shares was INR34370 million, and the balance amount of INR32885 million was not offered for taxation. The restructuring was with a motive to evade capital gains tax. The taxpayer transferred the stake outside India to Singapore entity and the period between slump sale and the transfer of ownership by giving away direct transfer to SSPL and indirect transfer to Actis was less than one year. The stake sale was to be taxed as short-term capital gains in the hands of the taxpayer. Explanation 2 to Section 2(47) of the Act was applicable to the taxpayer, and on reference to the provisions of Section 9 of the Act, the AO made the addition of INR32885 million to the income of the taxpayer.

- The Commissioner of Income-tax (Appeals) [CIT(A)] upheld the order of the AO. The CIT(A) held that capital asset, as mentioned in the provisions of Section 9 of the Act, would include shares as well as interests (stake) in a company or entity registered or incorporated outside India. The taxpayer had transferred its stake/interest to Singapore entity and made the indirect transfer to Actis. The transaction was covered by Explanation 5 to Section 9 of the Act. It was held that the group companies located outside India were having interest in taxpayer directly or indirectly. They were merely investment holding companies, and they existed merely on paper. The transfer of interest by the taxpayer in itself derived its value from the business/assets located in India. The transfer of interest by the taxpayer was held as income deemed to accrue or arise in India.

Tribunal's decision

- On a reference to capital gains taxation provisions, it has been observed that tax was to be levied on the capital value of certain assets, the capital value being computed in a particular manner. In other words, all assets were not taxed, but only those assets which were either sold, transferred or exchanged. It is not the intention of the Legislature to tax the full value of the capital asset as represented by the sale proceeds, but permissible deduction towards the actual cost can be made from the sale proceeds of that capital asset.

- Under Section 45 of the Act, the 'profits or gains arising from the transfer of a capital asset' are taxable, and the charge of income-tax on the capital gains is on the income of the previous year in which the transfer takes place. The only condition in order to attract tax under Section 45 of the Act is that the property transferred must be a capital asset on the date of transfer. The Tribunal relied on the decision of Chunnilal Prabhudas & Co[4].

- The Gujarat High Court in the case of Baroda Cement and Chemicals Ltd.[5] held that the two basic requirements for charging capital gains were (i) there must be a transfer of a capital asset (ii) profit or gains must have arisen from the transfer after making deductions as provided by Section 48 of the Act. The Gujarat High Court in the case of Mohanbhai Pamabhai[6] observed that the transfer of a capital asset in order to attract capital gains tax must be one as a result of which consideration would be received by the taxpayer or would accrue to the taxpayer. The Tribunal also relied on the decision of the Madras High Court in the case of Cadd Centre[7].

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[4] CIT v. Chunnilal Prabhudas & Co [1970] 76 ITR 566 (Cal)
[5] Baroda Cement and Chemicals Ltd v. CIT [1986] 158 ITR 636 (Guj)
[6] CIT v. Mohanbhai Pamabhai [1973] 91 ITR 393 (Guj)
[7] Cadd Centre v. ACIT [2016] 383 ITR 258 (Mad)

- In the present case, there was no transfer of capital asset to invoke the provisions of Section 45 of the Act. The taxpayer during the year sold some vehicles, and no other asset was sold. If no asset other than vehicles were sold, then the capital gain would not arise with respect to the shares.

- The acquisition of shares of SOHM by Actis cannot be used for determining the taxability of the taxpayer. Both the entities, i.e., Actis and SOHM, were not located in India. They were fifth generation holding companies, and any transaction between them cannot be imported to tax capital gains of the taxpayer. The taxpayer had acquired businesses of two Indian entities. The purchasing of shares of SOHM by Actis and the shares issued by the taxpayer to the Singapore entity, cannot be linked.

- The concept of 'creating of interest in any assets in any manner' and transferring 'interest/stake' was introduced[8] in the year 2013, and it was not part of the word 'transfer' for the year under consideration, and hence it was not applicable. On reference to the Explanation 5 of Section 9 of the Act, it has been observed that the Explanation covers the non-residents and not a resident entity. In the present case, the taxpayer is a resident company.

- The AO held that a multi-layered holding structure was deliberately created to avoid taxes in India and to conceal the information about the ultimate beneficiaries. However, the Tribunal observed that having AEs outside India in itself cannot be held against the taxpayer. Because of advancement of technology, the globe has become a village, and hence, the nature of business has altered. The taxpayers are free to decide the manner in which they want to run their businesses.

- A citizen is entitled to exercise his ingenuity so to arrange his affairs to make it possible for him legally and lawfully not to pay tax. However, if his ingenuity succeeds, the Court may acknowledge the cleverness of the taxpayer and must give effect to the letter of the taxation law rather than the strain that letter against the taxpayer. The Tribunal relied on the decision of Azadi Bachao Andolan[9].

- As far as non-cooperation of the taxpayer in providing necessary information is concerned, it has been observed that for not extending cooperation, the taxpayer should be dealt with relevant provisions of the Act. However, for that tax liability cannot be fastened to it without establishing the basic fact of existence and transfer of capital asset.

- Accordingly, the Tribunal held that the money received by the taxpayer for issuing shares has to be treated as capital receipt and cannot be brought to tax.

Our comments

Whether the issue of fresh equity shares is a transfer of capital asset has been a subject matter of debate before the Courts. The Supreme Court in the case of Khoday Distilleries Ltd.[10] in the context of Gift-tax Act, 1958 held that the shares would come into existence only on the allotment. There is a vital difference between 'creation' and 'transfer' of shares. The words 'allotment of shares' have been used to indicate the creation of shares by an appropriation out of the unappropriated share capital to a particular person. A share is a chose in action. A chose in action implies the existence of some person entitled to the rights in action in contradistinction from rights in possession. There is a difference between the issue of a share to a subscriber and the purchase of a share from an existing shareholder. The first case is that of creation whereas the second case is that of transfer.

The Mumbai Tribunal in the case of Sudhir Menon HUF[11] observed that a share does not exist prior to its allotment, and in that sense comes into existence only on its allotment. Allotment of a share is only the appropriation of the authorised share capital, being un-appropriated, to a particular person. In a nutshell, the difference between the issue of a share to a subscriber and a purchase of a share from an existing shareholder is the difference between the creation and transfer.

In the instant case, the Tribunal held that issue of fresh equity shares is not a transfer of capital asset. It is a capital receipt and therefore not taxable under the Act. The Tribunal observed that in order to attract the capital gains tax under Section 45 of the Act, the property transferred must be a capital asset on the date of transfer. However, in the instant case, there was no transfer of a capital asset.

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[8] Explanation 2 to Section 2(47) of the Act introduced the concept of 'creating of interest in any assets in any manner'
[9] UOI v. Azadi Bachao Andolan [2003] 263 ITR 706 (SC)

[10] Khoday Distilleries Ltd v. CIT [2009] 176 Taxman 142 (SC)
[11] Sudhir Menon HUF v. ACIT [2014] 45 taxmann.com 176 (Mum)

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