TAX FLASH NEWS

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Loss on cancellation of shares pursuant to capital reduction can be treated as long-term capital loss and it can be carried forward to subsequent years

Recently, the Mumbai Bench of the Income-tax Appellate Tribunal (the Tribunal) in the case of Carestream Heath INC[1] (the taxpayer) dealt with the issue of whether loss arising to a foreign company for cancellation of its shares in the Indian subsidiary pursuant to reduction of capital is allowed as long-term capital loss (LTCL) and whether such loss can be carried forward to subsequent years. The Tribunal held that the loss arising to the taxpayer for cancellation of its shares in the Indian subsidiary pursuant to reduction of capital can be allowed as LTCL and such loss can be carried forward to subsequent years.

Facts of the case

The taxpayer, a US based company, made investments to the extent of 64.76 million equity shares in wholly owned Indian subsidiary. During Assessment Year 2011-12, the Indian subsidiary undertook a capital reduction of its share capital pursuant to a scheme approved by the Bombay High Court. Under the capital reduction scheme, 29.13 million shares (out of 64.76 million equity shares) held by the taxpayer were cancelled and payment of INR399.99 million was received on account of such capital reduction. Out of the total consideration of INR399.99 million, the consideration of INR103.31 million was treated as accumulated profits of the Indian subsidiary and hence was treated as deemed dividend. Accordingly, dividend distribution tax (DDT) on such deemed dividend was paid by the Indian subsidiary and the taxpayer claimed an exemption under Section 10(34) of the Income-tax Act, 1961 (the Act). The balance consideration of INR 296.68 million was treated as sale consideration of the shares and capital loss was determined as per Rule 115A[2] of the Income-tax Rules, 1962 (the Rules). Accordingly, the taxpayer claimed LTCL upon cancellation of the shares held by it in the Indian subsidiary pursuant to capital reduction.

The Assessing Officer (AO) observed that the taxpayer held 100 per cent shares in the subsidiary company and even after the scheme of reduction of capital, the taxpayer was holding 100 per cent of the shares. Even by way of reduction of capital by cancellation of the shares, the rights of the taxpayer do not get extinguished. Therefore, the conditions of transfer were not satisfied. Accordingly, there was no transfer within the meaning of Section 2(47) of the Act. Thus, the AO disallowed the claim of LTCL and also did not allow it to carry forward.

The Dispute Resolution Panel (DRP) held that the taxpayer's case was squarely covered by the decision of the Special Bench of the Mumbai Tribunal in the case of Bennett Coleman & Co. Ltd[3]. The DRP held that the share of the taxpayer in the total share capital of the company as well as the net worth of the company would remain the same even after capital reduction or cancellation of shares. Thus, there was no change in the intrinsic value of the shares and the rights of the shareholder vis-a-vis the other shareholders as well as the company. Accordingly, loss cannot be said to have actually accrued to the shareholder as a result of the capital reduction. Consequently, the DRP disallowed the LTCL claimed by the taxpayer.

Tribunal's decision

The taxpayer had incurred capital loss only due to claim of indexation benefit and not otherwise. The benefit of indexation is provided by the statute and hence there cannot be any malafide intention that

[1] Carestream Heath INC v. DCIT (ITA No. 826/Mum/2016) – Taxsutra.com

[2] Rule 115A of the Rules - Rate of exchange for conversion of rupees into foreign currency and reconversion of foreign currency into rupees for the purpose of computation of capital gains under the proviso to clause (a) of sub-section (1) of Section 48 of the Act.

[3] Bennett Coleman & Co. Ltd v. ACIT (ITA No. 3013/ Mum/ 2007, dated 30 September 2011)

could be attributed on the taxpayer in claiming LTCL. The AO held that there was no transfer pursuant to reduction of capital. However, it was a fact that the taxpayer had indeed received a sale consideration of INR 399.99 million towards reduction of capital. This sale consideration was not sought to be taxed by the AO under any other head of income. This goes to prove that the AO had indeed accepted this to be sale consideration received on reduction of capital under the head 'capital gains' only as admittedly the same was received only for the capital asset i.e. shares. Hence the existence of a capital asset is proved beyond doubt. The capital gains were also capable of getting computed in the instant case as the cost of acquisition of shares of Indian company and sale consideration received thereon were available.

The Tribunal distinguished the decision of the Special Bench of the Mumbai Tribunal in the case of Bennett Coleman & Co. Ltd. The issue before the Special Bench was that the share capital was reduced to set off the accumulated losses and no consideration was paid from the company to its shareholders. The Special Bench was concerned with a case of substitution of one kind of share with another kind of share, which was received by the taxpayer because of its rights to the original shares on the reduction of capital. The taxpayer got the new shares on the strength of its rights with the old shares and, therefore, same would not amount to transfer. For this purpose, reference was made to Section 55(2)(b)(v) of the Act. The taxpayer therein had taken the cost of acquisition of the original shares as the cost of substituted shares, when capital gains were to be computed for the new shares. In the decision of the Special bench it was observed that though under the concept of joint stock company, the joint stock company is having independent legal entity but for all practical purposes, the company is always owned by the shareholders. The effective share of taxpayer in the assets of the company would remain the same immediately before and after reduction of such capital. Thus loss suffered by the company would belong to the company and that cannot be allowed to be set off in the hands of the taxpayer.

However, in the instant case, the taxpayer had indeed received the sale consideration of INR399.99 million towards reduction of share capital and the same has been accepted as such i.e. received for reduction of shares, being a capital asset, by the AO. Further, the provisions of Section 55(2)(b)(v) do not apply to the present case. The cost of acquisition of 29.13 million shares shall be of no relevance in the taxpayer's case at any later stage. The Tribunal relied on the decision of Supreme Court in the case of Vodafone International Holdings B.V[4] wherein it was held that the company and its shareholders are two distinct legal persons and a holding company does not own the assets of the subsidiary company.

[4] Vodafone International Holdings B.V. v. Union of India [2012] 314 ITR 1 (SC)

The tax department contended that the Special bench of the Mumbai Tribunal also relied on the decision of the Supreme Court in the case of Rasiklal Maneklal[5] (HUF). However, the Tribunal observed the decision of the Rasiklal Maneklal was considered by the Supreme Court in the case of Grace Collis[6]. The Supreme Court held that the rights of the taxpayer in the capital asset, being their shares in the amalgamating company, stood extinguished upon the amalgamation. Therefore, there was a transfer of the shares in the amalgamating company within the meaning of Section 2(47) of the Act. In the present case also, reduction of capital had resulted in 'Extinguishment of rights in shares' and the definition of 'transfer' under Section 2(47) of the Act includes 'extinguishment of any rights' in a capital asset.

The tax department relying on the decision of the Special Bench contended that the percentage of shareholding remains the same because reduction of shares had happened for all shareholders. However, the Tribunal held that the percentage of shareholding has got no bearing for chargeability of capital gains under the Act. The provisions of Section 55(2)(b)(v) of the Act were applied in the decision of the Special Bench. However, in the present case, the provisions of Section 55(2)(b)(v) of the Act was not applicable at all and if the taxpayer was not given the benefit, it would never get it and none of the clauses of Section 55(2)(b)(v) of the Act would be applicable to the taxpayer in the instant case.

The Tribunal relied on various decisions[7] referred by the taxpayer on the proposition of reduction of capital amounts to transfer under Section 2(47) of the Act. Even though the shareholder remains a shareholder after the capital reduction, first right as a holder of those shares stands reduced with the reduction in the share capital.

Accordingly, the Tribunal held that the loss arising to the taxpayer for cancellation of its shares in the Indian subsidiary pursuant to reduction of capital should be allowed as LTCL eligible to be carried forward to subsequent years.

Our comments

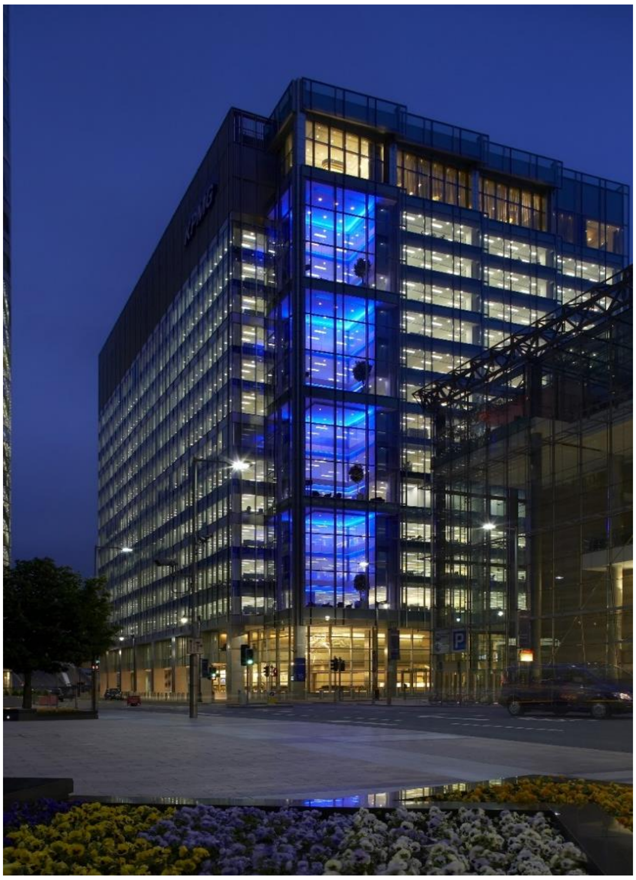
The Special Bench of the Mumbai Tribunal in the case of Bennett Coleman had disallowed a shareholder's claim for capital loss on reduction of share capital since the shareholder's percentage of shareholding, immediately before as well as after the reduction of share capital remained the same. Also, there was no consideration received by the shareholder in lieu of reduction of share capital and hence, the Tribunal termed the shareholder's claim as merely a notional loss which was not allowed. On the other hand,

[5] CIT v. Rasiklal Maneklal (HUF) [1989] 177 ITR 198 (SC)
[6] CIT v. Grace Collis [2001] 248 ITR 323 (SC)
[7] Kartikeya V Sarabhai v. CIT [1997] 228 ITR 163 (SC), CIT v. G Narasimhan [1999] 236 ITR 327 (SC), Jupiter Capital Pvt. Ltd. v. ACIT (ITA No.445/Bang/2018, dated 29 November 2018)

the Bangalore Tribunal in the case of Jupiter Capital Pvt. Ltd. allowed the claim for capital loss on account of reduction in share capital of the company. In this case, the taxpayer received consideration in lieu of reduction of share capital.

In the present case, the Mumbai Tribunal held that the loss arising to the taxpayer for cancellation of its shares in the Indian subsidiary pursuant to reduction of capital should be allowed as LTCL eligible to be carried forward to subsequent years. The Tribunal relied on various decisions on the proposition of reduction of capital amounts to transfer under Section 2(47) of the Act. The Tribunal in this case distinguished the decision of Bennett Coleman and observed that the percentage of shareholding has got no bearing for chargeability of capital gains under the Act. It was observed that the taxpayer had indeed received the sale consideration towards reduction of share capital and the same has been accepted as such i.e. received for reduction of shares, being a capital asset, by the AO. The Tribunal also observed that the taxpayer had incurred capital loss only due to claim of indexation benefit and not otherwise. The benefit of indexation is provided by the statute and hence there cannot be any malafide intention that could be attributed on the taxpayer in claiming LTCL.

Considering the above decision, whenever a capital reduction process results in a loss for the shareholder, whether such loss would be allowable or not, would depend upon various parameters for e.g. whether any consideration was paid to the shareholder in lieu of the capital reduction, whether the rights associated with the particular shares (which were available before capital reduction) remain intact post the capital reduction, etc.



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