



Tax Flash News



24 November 2024

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Genuine business loss v. sham transaction: Delhi High Court upholds commercial wisdom

Executive summary



The assessment of tax liabilities often involves a delicate balance between scrutinising transactions for compliance and respecting the commercial judgements of businesses.

The tax authorities allege that certain transactions are structured to avoid tax liability, while taxpayers assert that such transactions are *bona fide* and necessary for business purposes. In such cases, the judiciary plays a crucial role in determining whether the transactions are genuine or constitute colourable devices.

In the case of *G-Tekt India*¹, the dispute concerned the disallowance of business loss claimed by the taxpayer arising from the purchase and resale of tools and dies required for manufacturing automotive components.

The Revenue contended that the transaction was a sham intended to artificially inflate losses, while the taxpayer maintained that the losses were genuine and stemmed from commercially necessary decisions to secure a critical business relationship.

¹ *PCIT v. G-Tekt India Pvt Ltd* (ITA No. 463/2024). Source: Taxsutra

The Delhi High Court, ruling in favour of the taxpayer, emphasised the principle that commercial decisions made in good faith should not be questioned by tax authorities without substantive evidence of malpractice

Facts of the case



The taxpayer, an Indian company, was engaged in the manufacturing and sale of automotive parts and components. It was an OEM (original equipment manufacturer) supplier to HCIL.

To carry out the manufacturing of components, the taxpayer purchased the tools and dies from HTIPL² which was a group company of HCIL.

Following procurement, these tools and dies were sold by the taxpayer to HCIL at a price which was much lower than the purchase price.

The tools were subsequently handed back to the taxpayer by HCIL for use in manufacturing automotive components.

The above transaction of the purchase and sale of tools and dies resulted in loss which was claimed by the taxpayer in its tax return.

The taxpayer justified this arrangement as part of a broader business strategy to secure manufacturing contracts with HCIL, which led to significant growth in turnover.

However, the tax officer flagged the transaction as a sham, alleging that it was designed to generate artificial losses and lacked the commercial necessity for the taxpayer to act as an intermediary in the transaction.

Taxpayer's Contentions



The instant transaction has commercial expediency. It ensured that HCIL provided manufacturing contracts to the taxpayer, leading to an increase in turnover and potential future profits, demonstrating the benefits of the transaction.

It was necessary for the taxpayer to procure the dies at its own cost and claim depreciation on it.

² Partly from HTIPL and partly from another third-party supplier

To minimise the risk/ cost, the taxpayer requested HCIL to provide the dies to manufacture the specific parts as required by HCIL.

However, HCIL demanded the taxpayer to procure and sell the tools and dies so that HCIL can pay for the same. In terms of the business arrangement, the taxpayer transferred the ownership of dies to HCIL.

HCIL had obtained quotes from other suppliers and set the purchase price based on the lowest quote. The taxpayer accepted these terms to secure the business opportunity.

Thus, the pricing of the tools and dies was based on negotiations and competitive quotes obtained by HCIL, negating any suggestion of collusion or artificial pricing..

Revenue's Contentions



The arrangement was a colourable device aimed at inflating losses artificially. The involvement of HTIPL (a sister concern of HCIL) in the transaction was evidence of a coordinated effort to evade taxes.

HCIL could have directly purchased the tools and dies instead of routing the transaction through the taxpayer, which added an unnecessary layer of complexity and purportedly lacked commercial rationale.

High Court decision



The Delhi High Court rejected the tax officer's stance that the transaction was a sham.

The transaction was *bona fide* and entered into based on sound commercial reasoning. The tax officer had no jurisdiction to question the commercial expediency of the transaction.

HTIPL was not an affiliate entity of the taxpayer.

The involvement of HTIPL, a sister concern of HCIL, did not inherently render the transaction suspicious. Moreover, no evidence suggested that the taxpayer had received undisclosed payments or engaged in clandestine arrangements to reverse the loss.

The High Court accepted the taxpayer's explanation that the arrangement with HCIL, despite initial losses, was necessary to secure a long-term business relationship and subsequent profitability.

The High Court further observed that even if the taxpayer had not been able to earn profits in the later years, the same would make no difference. It is not necessary that every business decision made by the taxpayer yields profit.

The Court found the Revenue's appeal to be without merit, citing that it was based on assumptions and lacked substantive evidence.

Our comments



The judgment reinforces the importance of recognising commercial prudence in assessing tax matters. It emphasised that tax authorities cannot supplant their judgement of commercial expediency over that of the taxpayer.

This case also highlights the need for Revenue to present substantive evidence before branding the transactions as sham or artificial.

The ruling is also a reminder to businesses to maintain robust documentation to support their decisions.



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