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TAX FLASH NEWS

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Sale of shares of an Indian company by a foreign company is not a sham transaction and therefore long term capital loss on such transaction is eligible to set off and carry forward

Recently, the Mumbai Bench of the Income-tax Appellate Tribunal (the Tribunal) in the case of Swiss Reinsurance Company Ltd[1] (the taxpayer) dealt with the issue of eligibility of set off or carry forward of long term capital loss resulting from sale of shares of an Indian company by a foreign company. The Tribunal held that sale of shares of an Indian company by a foreign company is not a sham transaction and therefore long term capital loss on such transaction is eligible to set off and carry forward.

Facts of the case

The taxpayer, a Switzerland based entity, is a global re-insurer and provides re-insurance services to various insurance companies, including, Indian insurance companies through its branches across the globe.

The taxpayer has a wholly owned subsidiary in India (TTK) with which the taxpayer has entered into an agreement for availing certain services. The taxpayer was holding 12,34,476 shares constituting about 26 per cent of the total shares of an Indian company. These shares were acquired by the taxpayer in tranches under the Foreign Direct Investment (FDI) route during the period from 8 March 2007 to 5 August 2010. All the shares having face value of INR 10/- were acquired by the taxpayer with premium varying between INR 35 to INR 5,141.

During the year Assessment Year 2014-15, the taxpayer sold all its shares to an Indian company at mutually agreed terms of INR 5 per share. In the process, the taxpayer incurred long term capital loss of INR 499.24 million and carry forward of such loss was claimed in the return of income.

The Assessing Officer (AO) observed that despite the fact that TTK was incurring cash loss in financial years 2008-09 and 2009-10, the taxpayer went ahead in buying shares with heavy premium. There was no justifiable reason for the taxpayer in investing in shares of TTK with very high premium and thereafter selling them at huge loss. The AO held that the long-term capital loss claimed by the taxpayer on sale of shares was an artificial loss; hence, cannot be allowed. Accordingly, the AO disallowed the long-term capital loss claimed by the taxpayer and consequently, denied the carry forward of the said loss to subsequent assessment year. The Dispute Resolution Panel (DRP) concurred with the decision of the AO that the loss claimed by the taxpayer was an artificial loss.

Tribunal's decision

On a perusal of documentary evidences, it was observed that the shares of TTK purchased on different dates between 8 March 2007 and 5 August 2010 with a premium was approved by the regulatory authorities, such as, Insurance Regulatory and Development Authority (IRDA) and Reserve Bank of India (RBI).

As per Foreign Exchange Management Act (FEMA) regulations, the taxpayer cannot hold more than 26 per cent of the total shareholding under the Foreign Direct Investment (FDI) route. There was no allegation that the aforesaid condition has been violated by the taxpayer. The taxpayer had explained the reasons for purchasing the shares at high premium. The taxpayer has explained the extent of control and management taxpayer was having in TTK after acquiring the shares.

Further, as per FEMA regulations the price of unlisted shares issued to a foreign company should not be less than the valuation of shares done by a chartered accountant as per DCF method. Complying with the aforesaid regulation, shares of TTK were issued to the

[1] Swiss Reinsurance Company Ltd v. DCIT (ITA No. 6531/Mum/2017) – Taxsutra.com

Note: The Tribunal has dealt with several issues. However, this flash news deals with the issue of eligibility of set off or carry forward of long term capital loss resulting from sale of shares of an Indian company by a foreign company taxpayer at a price not less than the fair market value (FMV) as per the valuation report. As regards the decision of investing in shares at a high premium, it is a commercial decision of the taxpayer and is not in violation of any rules or regulations including FEMA regulations.

TTK explained the reason for selling shares to the taxpayer at a substantially high premium as against sale of similar shares to resident shareholders at face value of INR 10 and thereafter there was no adverse observation/action by the regulatory authority with regard to the sale of shares.

At the time of sale of shares by the taxpayer, as per the valuation report, value of shares was determined at INR 7.19 per share. Therefore, the sale of shares by the taxpayer at INR 5 per share is not in excess of the value of share determined by the valuer, in compliance with the FEMA regulations. It is a matter of record that the sale of shares by the taxpayer to Indian entity at the agreed price of INR 5 per share has been approved and sanctioned by the regulatory authorities, such as, IRDA.

Therefore, when the purchase and sale of shares of TTK by the taxpayer are within the legal framework, there was no justification on the part of the departmental authorities in imputing motive and alleging that the transaction was arranged to create artificial loss.

The taxpayer had purchased a capital asset by way of shares and after holding it for certain period, has sold it at a loss. The fact that the shares sold by the taxpayer were long term capital asset was not disputed. Therefore, once the taxpayer had sold its long term capital asset, the computational provisions contained in Section 48 and 49 would automatically get triggered and the gain/loss arising out of such transaction had to be computed in terms of Sections 48 and 49. In the facts of the present case, undisputedly, after applying the computational provisions of Sections 48 and 49 to the sale transaction of shares of TTK, long term capital loss arises. Therefore, the taxpayer was entitled to claim such long-term capital loss.

Rule 11UA is applicable for valuation of assets specified under Section 56(2)(vii), 56(2)(viia) and 56(2)(viid). Therefore, Rule 11UA cannot be applied for determining the value of unlisted equity shares for any purpose other than Section 56(2).

Further, the taxpayer, on its part, had furnished valuation report of an expert determining the value of shares. Whereas, no such valuation was done by the AO to counter taxpayer's valuation. Similarly, the allegation of the AO that the promoter of an Indian company was linked to the taxpayer was wholly irrelevant.

As regards the allegation of the AO that the taxpayer had invested in TTK at a premium and thereafter sold the shares at a loss to benefit foreign investment firm, was totally irrelevant for deciding the issue in dispute.

Accordingly, it was held that the taxpayer having incurred long term capital loss in the course of a genuine transaction relating to sale of shares, is eligible to claim set off and carry forward of such loss.

Our comments

There is a long-drawn litigation on determination of whether a transaction or series of transactions amounts to a colourable device or a sham transaction for avoidance of tax. The Supreme Court in the case of McDowell & Co.[2] observed that tax planning may be legitimate provided it is within the framework of law. Colorable devises cannot be a part of tax planning and it is wrong to encourage such dubious methods to avoid payment of tax.

The Supreme Court in case of Vodafone International Holdings BV[3] while dealing with the decisions of McDowell's and Azadi Bachao Andolan[4] observed that it is only when colourable artificial devices are used to evade taxes, the transaction should be ignored. It does not disregard legitimate tax planning. The parameters to check these aspects are, whether a holding structure has a definite and strong business rationale, it has been in existence for a long period of time and there is generation of taxable revenues of the business per se in India, etc.

After the Supreme Court's decision, in various cases, the Courts / Tribunal have applied such observations to determine whether the transaction is sham or not. In the case of Consolidated Finvest & Holdings Limited[5], the Delhi Tribunal examined a series of transactions between two related entities which resulted in a capital loss in the hands of one entity and determined that there was no tax avoidance. The Tribunal observed that the AO was not able to provide any reasoning or evidence for holding it to be a sham except the fact that the transaction resulted in long term capital loss.

Similarly, in Copal Research Limited[6], the primary issue before the Delhi High Court was whether the taxpayer's transaction amounted to a prima facie avoidance of tax. The Delhi High Court held that the taxpayer's transaction was not structured primarily for the purpose of tax avoidance. This was on the basis that the taxpayer had sufficient commercial reasons for carrying out the transaction in that manner.

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[2] McDowell & Co v. CIT [1985] 154 ITR 148 (SC)
[3] Vodafone International Holdings BV v. UOI [2012] 341 ITR 1 (SC)
[4] UOI v. Azadi Bachao Andolan [2003] 263 ITR 706 (SC)
[5] DCIT v. Consolidated Finvest & Holdings Limited (ITA No.494/Del/201) (Del)
[6] DIT v. Copal Research Ltd [2015] 371 ITR 114 (Del)

In the present case, the Mumbai Tribunal based on facts of the case observed that as regards the decision of investing in shares at a high premium, it was a commercial decision of the taxpayer and it was not in violation of any rules or regulations including FEMA regulations. The purchase and sale of shares of Indian company by the taxpayer were within the legal framework. The taxpayer incurred long term capital loss in the course of a genuine transaction relating to sale of shares and hence is eligible to claim set off and carry forward of such loss.

It is important to note that the provisions of General-Anti Avoidance Rules (GAAR) have come into effect from Assessment Year 2018-19[7]. GAAR provisions are applicable if the transaction is an impermissible avoidance arrangement. The term 'impermissible avoidance arrangement' has been defined in these provisions. Under the provisions of GAAR, it is important to prove that the main purpose of transaction is to obtain the tax benefit. Further one of the additional conditions is to justify that the transaction lacks commercial substance or is deemed to lack commercial substance.

In addittion to introduction of GAAR provisions, to tackle the tax avoidance transactions, in last few years India has introduced 'limitation of benefit' (LOB) clause in several Indian tax treaties. Further India has ratified the MLI and included almost all of its tax treaties as Covered Tax Agreement (CTA). Thus Principal Purpose Test (PPT) which is a minimum standard will apply to all CTAs of India. PPT clause is wider in scope than the GAAR provisions. Under the PPT, benefits emanating from tax treaties can be negated if the main or even one of the principal purposes is to obtain a benefit. However, the PPT provisions also provides safeguards that if it is established that granting the benefit is in accordance with the object and purpose of the relevant provisions of the CTA then such provisions will not apply.

Thus determination of whether the transaction is sham or not is a fact based exercise and one needs to carefully analyse the transactions / structures undertaken to avoid the exposure to anti-avoidance provisions.

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[7] Financial Year 2017-18

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