

Tax Flash News

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Capital loss arising from the cancellation of shares of a company is allowable to the shareholders even if no consideration is paid by the company

The Mumbai bench of the Tribunal in the case of Tata Sons Limited¹ (the taxpayer) held that the reduction of the share capital of a company by way of the cancellation of shares is an extinguishment of rights in shares and is to be treated as a 'transfer' for applying capital gains tax provisions.

The Tribunal also held that the capital gains tax provisions will apply even if no consideration is actually payable by the company provided the consideration is otherwise conceivable or ascertainable.

The Tribunal set aside the revisionary order passed by the Principal Commissioner of Income-tax (PCIT) rejecting the claim of long-term capital loss allowed by the tax officer. The Tribunal observed that when there were different possible views and the tax officer had followed one possible view, the order of the tax officer could not be held as erroneous and could not be set aside or cancelled by the PCIT.

Facts of the case

- The taxpayer held the equity shares in an Indian company, Tata Tele-Services Company Ltd. (TTSL).
- In view of the losses incurred by TTSL, its shareholders and TTSL entered into a restructuring scheme in accordance with the provisions of the Companies Act, 1956² and the scheme was approved by the High Court.
- Pursuant to the scheme, the number of equity shares of TTSL was reduced from 6.34 billion to 3.17 billion and the paid-up equity share capital was also reduced correspondingly.

- Such a reduction in the share capital was adjusted against the accumulated debit balance in the profit and loss account and the share premium account.
- No consideration was payable by TTSL to its shareholders in respect of the cancelled shares.
- The taxpayer, relying on various decision³, claimed long-term capital loss (LTCL) on account of the reduction of the share capital held by it in TTSL and set off the loss against long-term capital gains (LTCG) earned by it from another transaction.
- The tax officer accepted the above position of the taxpayer.
- The PCIT revised the order of the tax officer under section 263 of the Income-tax Act, 1961 (the Act) and disallowed the claim of LTCL on the following grounds:
 - The transfer of a capital asset, in order to attract the capital gains tax provisions, must be a transfer as a result of which the consideration is received by, or accruing to, the taxpayer⁴. If there is no consideration received or accruing as a result of the transfer, the computational provision enacted in section 48 would be inapplicable.

¹ *Tata Sons Limited v. CIT* (ITA No. 3468/Mum/2016) (Mum) - Source: Taxsutra

² Sections 100 to 103 and 391 of the Companies Act, 1956

³ *Kartikeya Sarabhai v. CIT* [1997] 228 ITR 163 (SC), *CIT v. G. Narasimhan* [1999] 236 ITR 327 (SC), *CIT v. D.P. Sandhu Brothers Chembur Pvt. Ltd.* [2005] 273 ITR 1 (SC).

⁴ *CIT v. Mohanbhai Pamabha* [1973] 91 ITR 393 (Guj)

- Accordingly, the loss arising from the capital reduction in the instant case was not an allowable capital loss. At best, such a loss was a notional loss which could not be set off against LTCG.
- In the instant case, it was not a mere reduction in the face value of shares but an effacement of the shares, and corresponding capital, of the company.
- In the case of an effaced capital asset, the consideration received or accrued was 'nil' (non-existing consideration) and not 'zero'.
- The Supreme Court's decision in *Kartikeya Sarabhai* was not applicable as the taxpayer's case was not that of a reduction in the face value of the shares but an effacement of the entire share.
- The Mumbai special bench of the Tribunal in *Bennett Coleman & Co.*⁵ held that the replacement or substitution of earlier shares by the new shares did not amount to transfer.

Tribunal's decision

- Referring to the Supreme Court's decisions⁶, the Tribunal noted a distinction between the situations where it was possible to conceive of consideration being accruing or receivable as a result of the transfer and where it was not so possible at all. In the former case, the capital gains tax provisions would apply even if no consideration was actually payable.
- Section 100(1) of the Companies Act, 1956 provided the manner in which reduction of capital can be effected. It also envisaged to pay any paid-up capital which is in excess of the company's requirements. Thus, there was a consideration envisaged in some cases of capital reduction.
- The Gujarat High Court in *Jaykrishna Harivallabhdas*⁷ rejected the contention of the Revenue that the provision of capital gains tax should apply only when there was an actual receipt of consideration. The Court held that accepting Revenue's argument would mean that where a sum was received, howsoever negligible or insignificant it may be, it would result in the computation of capital gains or loss; however, where there was nil receipt of

capital, no loss could be computed. Such an incongruous and anomalous result should be avoided. There could be no distinction between the situations where the taxpayer received some negligible or insignificant consideration and where it received nil consideration.

- The Tribunal in the instant case held that:
 - A reduction of capital was the extinguishment of the right in the shares and it amounted to a transfer under section 2(47) of the Act.
 - The loss on reduction of share capital was an allowable capital loss and not a notional loss.
 - Even when the taxpayer had not received any consideration on the reduction of capital resulting into capital loss, such loss was to be allowed or set off against other capital gains.
- The decision in *Bennett Coleman & Co.* was a case of substitution of shares and was not applicable to facts in the present case.
 - In that decision, the majority judgment held that the loss arising on account of a reduction in share capital cannot be subject to sections 45 and 48. The said loss was not allowable as a capital loss. At best, such loss can be described as notional loss.
 - However, the accountant member held that the reduction of capital of a company by any mode has the effect of reducing the liability of the company. Its shareholders, to the extent of the capital reduced, is deprived of their right to receive that part of the share capital. The charge under section 45 shall be attracted where the cost of acquisition or full value of consideration is conceivable or ascertainable but is nil.
- However, the ratio of the majority judgment can be interpreted against the taxpayer as it was clearly held that in case of reduction of shares where no consideration was received, computation of capital gain and loss cannot be made, even though facts were different in that case.
- The Tribunal did not rely on the minority judgment, but the instant case was of revisionary jurisdiction under section 263 of the Act. The accountant member's decision suggested that the allowability of capital loss on reduction of share capital was a possible view. If such one possible view was taken by the tax officer in favour of the taxpayer, then it could not be held that the order of the tax officer was erroneous and therefore, such an order could not be set aside or cancelled.

⁵ *Bennett Coleman & Co. Ltd v. CIT* [2011] 12 ITR (T) ITR 97 (Mum) (SB)

⁶ *CIT v. B. C. Srinivasa Setty* [1981] 128 ITR 294 (SC) and *CIT v. D.P.*

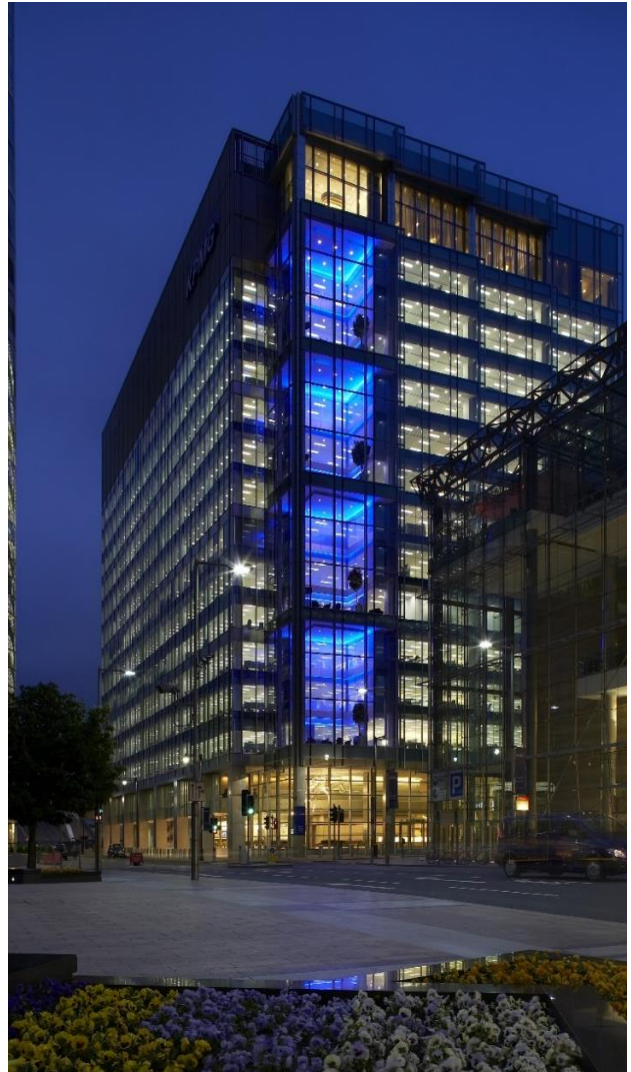
Sandhu Brothers Chembus Pvt Ltd. [2005] 273 ITR 1 (SC)

⁷ *CIT v. Jaykrishna Harivallabhdas* [1997] 231 ITR 108 (Guj)

- The Tribunal followed the decision in Jaykrishna Harivallabhdas over the majority judgment in Bennett Coleman & Co.
- The Tribunal held that the tax officer rightly allowed the computation of LTCL to be set off against the capital gain.

Our comments

The Tribunal has dealt with the issue of allowability of capital loss on reduction of share capital. The observations of the Tribunal will help the taxpayers to claim the capital loss where no consideration accrues or is actually received. This is a case of revisionary jurisdiction by the PCIT and the Tribunal has followed the Gujarat High Court's decision over the decision of the Mumbai special bench of the Tribunal. It would be interesting to see how other courts will deal with this matter.



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