



Tax alert: For exclusion from transfer, entire share capital should include preference and equity share capital

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The Mumbai Bench of the Income-tax Appellate Tribunal (ITAT), based on facts of the case, has rendered its decision that the taxpayer held 100% equity share capital of its subsidiary, but did not hold preference share capital. Thus, the taxpayer did not hold the 'whole of the share capital' of the subsidiary company and accordingly, conditions prescribed under section 47(iv)(a) of the Income-tax Act, 1961 (providing for exclusion from transfer), did not get satisfied.

In a nutshell



'Whole of the share capital', as provided under section 47(iv) of the ITA, would include **'equity and preference share capital'** both, as the section does not provide any reference of holding of only equity share capital.



Though the taxpayer held 100% equity share capital of B Co, but did not hold preference share capital of the B Co. Thus, the taxpayer did not hold the 'whole of the share capital' of the subsidiary company. Accordingly, conditions prescribed under section 47(iv)(a) of the ITA, did not get satisfied.



When the conditions of section 47(iv) of the ITA are not satisfied the capital gain or loss arising on transfer of a capital asset by the taxpayer to its subsidiary company, would be chargeable to tax under the normal provisions of section 45 of the ITA.



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Background:

- The taxpayer¹ an Indian company, held equity shares and non-cumulative compulsorily convertible preference shares (CCPS) of a company (say A Co), which was also taxpayer's wholly owned subsidiary (WOS).
- During the Financial year (FY) 2012-13, corresponding to the Assessment Year (AY) 2013-14, the taxpayer sold all the equity shares and CCPS of A Co to its Indian subsidiary (say B Co). The taxpayer incurred long-term capital loss (LTCL) on sale of such equity shares and CCPS of A Co.
- The taxpayer did not claim the aforesaid LTCL in its return of income on the understanding that the aforesaid transaction was covered as an exempt transfer under section 47(iv) of the Income-tax Act, 1961 (ITA) [relating to certain 'transfer' being exempt from capital gains tax provisions].

As per section 47(iv) of the ITA *"Nothing contained in section 45 shall apply to the following transfers...*

...(iv) any transfer of a capital asset by a company to its subsidiary company, if—

*(a) the parent company or its nominees hold the **whole of the share capital** of the subsidiary company, and*

(b) the subsidiary company is an Indian company..." (emphasis supplied)

- During the course of appellate proceedings before the Mumbai Bench of the Income-tax Appellate Tribunal (ITAT), amongst others, the taxpayer raised an additional ground claiming LTCL on sale of equity shares and CCPS of A Co on the following basis:
 - Taxpayer had incurred LTCL on sale (to B Co) of equity shares and CCPS of A Co. It was an erroneous understanding that the said transaction fell within the exception to the definition of 'Transfer' under section 47(iv) of the ITA.
 - Taxpayer did not hold whole of the share capital of B Co. It only held 100% equity shares of B Co but did not hold any preference shares of B Co.
 - B Co had also issued preference shares of different coupon rate, which were not held by the taxpayer but were held by other companies.
 - Since the 'whole of share capital', which should comprise of both the equity share capital and preferential capital of B Co, was not held by the taxpayer, the provisions of section 47(iv) of the ITA were not applicable to the taxpayer.

Decision of the ITAT:

The ITAT noted / observed as follows:

Provisions of section 47(iv) of the ITA

- According to section 47 of the ITA, the provision of section 45 of the ITA (relating to capital gains) does not apply to certain specified transfer. As per 47(iv) of the ITA, if there is a transfer of a capital asset by a company to its **Indian subsidiary company**, and parent company along with its nominees, hold the **whole of the share capital** of the subsidiary company, then, transfer of such capital asset shall not be chargeable to tax under the head capital gain in terms of provisions of section 45 of the ITA.
- In present case, there is a transfer of a capital asset by taxpayer to its subsidiary company (viz. B Co), which is also an Indian company. The only dispute was that whether taxpayer held the **whole of the share capital** of B Co.

¹ Reliance Industries Limited vs. ACIT, Large taxpayer unit, Mumbai [2022] ITA No. 7299/Mum/2017 (Mum-Trib.)

- The taxpayer held 100% of the equity share capital of its subsidiary viz. B Co. However, it did not hold any of the preference share capital of its subsidiary company viz. B Co.

Taxpayer did not hold 'whole of the share capital' of B Co

- Section 47(iv) of the ITA provides that, provisions 45 of the ITA does not apply to the transfer of capital asset by a company to its subsidiary company. This is subject to the condition that subsidiary company is an Indian company and the holding company along with its nominees, held the whole of the share capital of the subsidiary company.
- Though, the taxpayer held 100% equity share capital of B Co, but did not hold preference share capital of the B Co. Thus, it did not hold the '**whole of the share capital**' of the subsidiary company. Accordingly, conditions prescribed under section 47(iv)(a) of the ITA did not get satisfied.
- Therefore, provisions of section 45 of the ITA were triggered and, any profit or gain arising on the sale of A Co shares to B Co was chargeable to tax under the head capital gains.
- Share capital includes '**equity and preference share capital**' both. There is no reference of holding of only equity share capital under section 47(iv) of the ITA. Therefore, the capital loss arising to the taxpayer on sale of shares by taxpayer to its subsidiary company were eligible capital loss.

Relevant provisions of the Companies Act, 2013

- Provisions of section 86 of the Companies Act, 2013 provides that share capital of the company limited by shares shall be of two kinds - equity share capital and preference share capital. The '**whole of the share capital**' should include holding of equity share capital and preference share capital, both.
- The ITA does not contain any definition of 'share capital'. The Companies Act 2013 also does not define it. The Companies Act, 2013 as per section 2(84) defines 'share' to mean a share in the share capital of a company and includes stock. Chapter IV of the Companies Act, 2013 deals with the provisions of 'Share capital' of the company.
- Section 42 of The Companies Act, 2013 provides that share capital of a company limited by shares shall be of two kinds:
 - (i) equity share capital with voting rights or with differential rights as to dividend, voting or otherwise in accordance with such rules as may be prescribed,
 - (ii) preference share capital.

The explanation (i) and (ii) to that section defines what is 'equity share capital' and what is 'preference share capital'.
- The Companies (Share Capital and Debentures) Rules, 2014 provides for conditions for issue of certain shares. Thus, the equity share capital could be with voting rights or with differential rights as to dividend, voting or otherwise as provided under rule 4 of the aforesaid rules. Similarly, preferential share capital carries a preferential right with respect to payment of dividend and for prepayment of capital at the time of winding up.

Whether the taxpayer holds 'whole of share capital'?

- The 'share capital' includes equity as well as preference shares both. The share capital derived its meaning from the Companies Act which includes equity and preference capital both.
- Wherever the legislature wanted particular percentage of particular share capital qua voting right, etc, same was provided in those sections, such as section 47(xiii) and (xiv) of the ITA [relating to exempt 'transfer' in case of certain succession]. Similarly, section 2(22) and section 40A of the ITA provides for beneficial ownership of shares.

- Section 47(iv) of the ITA exempts transfer of capital assets from holding company to subsidiary company only where share capital in its entirety was held by holding company. Therefore, the requirement of holding the **‘whole of the share capital’** applied to both the types of share capital i.e. equity share capital and preference share capital.
- Thus, it was apparent that entire issued and paid-up share capital of the subsidiary company should be held by holding company or its nominees for claiming exemption from capital gains under the said clause [viz. section 47(iv) of the ITA].
- In the case under consideration, there were different shareholders of preference share capital other than the holding company and holding company only held along with its nominees, 100% equity shares of the transferee company. Therefore, the conditions of section 47(iv) of the ITA were not satisfied and if any capital gain or loss arose on transfer of a capital asset by the taxpayer to its subsidiary company, the capital gain or loss was chargeable to tax under the provisions of section 45 of the ITA.

In view of the above, the ITAT held that capital gain or loss arising to the taxpayer on transfer of A Co’s shares to B Co was not tax-exempt under section 47(iv) of the ITA.

Comments:

- Transactions qualifying under the provisions of section 47 of the ITA are not considered as transfer and accordingly, not subjected to capital gains tax. Thus, any loss arising from such transaction may not be set-off or carried forward.
- Exclusion from ‘transfer’ of capital asset from holding company to subsidiary company under section 47(iv) of the ITA is subject to the condition that subsidiary company is an Indian company and the holding company along with its nominees, hold the whole of the share capital of the subsidiary company.
- The ITAT in this ruling, based on facts, has held that in order to fulfil the condition of section 47(iv) of the ITA, the taxpayer needs to hold ‘whole of the share capital’ which would include equity as well as preference share capital. While holding the same, the ITAT has held that:
 - ‘Whole of the share capital’ provided under section 47(iv) of the ITA includes **‘equity and preference share capital’** both, as the section does not provide any reference of holding of only equity share capital. Entire issued and paid-up share capital of the subsidiary company should be held by holding company or its nominees for claiming exemption from capital gains under the said clause [viz. section 47(iv)].
 - Though, the taxpayer held 100% equity share capital of B Co but, it did not hold preference share capital of the B Co. Thus, the taxpayer did not hold the **‘whole of the share capital’** of the subsidiary company. Accordingly, conditions prescribed under section 47(iv)(a) of the ITA did not get satisfied.
 - When the conditions of section 47(iv) of the ITA are not satisfied the capital gain or loss arising on transfer of a capital asset by the taxpayer to its subsidiary company, would be chargeable to tax under the normal provisions of section 45 of the ITA.

Taxpayers with similar facts may evaluate the impact of this ruling to the specific facts of their cases.



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