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Tax alert: Gain from sale of investment in joint venture taxable as capital gains

31 October 2023

The Mumbai Bench of the Income-tax Appellate Tribunal, based on facts of the case, has held that the gain arising on sale of investment in joint venture company shares by the taxpayer would be chargeable to tax under the head capital gains.

In a nutshell

- According to the look-at test, the task of the Revenue is to ascertain the legal nature of the transaction. While doing so, it has to look at the entire transaction holistically and not adopt a dissecting approach.
- Acquisition of shares may carry the acquisition of controlling interest, which is purely a commercial concept and tax is levied on the transaction, not on its effect.

The Income-tax Act, 1961 (ITA) does not contain provisions to state that determination of the head of income under which the gain on sale of shares is to be taxed, is based on the valuation used for arriving at sale consideration for transfer of shares. However, the AO has the right to question the correctness of the valuation and accordingly determine the treatment of the taxability of the amount which in his opinion is in excess.

The treatment of shares in the books of accounts, whether as stock-in-trade or as investment, is one of the determining factors for taxation under capital gain or business income and it cannot be said that the method adopted for arriving at the sale consideration determined the nature of transaction.

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Background:

- The taxpayer[1] is a holding company and had invested in the joint venture ABC Ltd. (ABC JV) in which the taxpayer held 49% along with another company (A Co) which held the remaining 51% in ABC JV.
- During Financial Year (FY) 2007-08, corresponding to Assessment Year (AY) 2008-09, the taxpayer sold its 49% investment in ABC JV to A Co and treated the gain on sale of ABC JV shares as long-term capital gain.
- During audit proceedings, the Assessing Officer (AO) proceeded to treat the gain as business income of the taxpayer for the reason that the taxpayer was in the business of shares and securities as a broker and was also involved in share trading business.
- Aggrieved, the taxpayer filed an appeal and in the course of remand proceedings[2], the AO held that the consideration was required to be taxed in terms of section 28(ii) of the Income-tax Act, 1961 (ITA) as business income, for the following reasons:
  - The entire consideration received was not the value of the shares but was for the value of business interest for which sale of shares was used as a medium.
  - With regard to the applicability of the earlier SC ruling[3], the AO held that in the case before the SC:
    - The parties involved were non-residents whereas in the case under consideration, the transaction was between two entities.
    - The issue of taxability under section 28(ii) of the ITA was not adjudicated.
    - The issue was with regard to the taxability of the profit whereas in the case under consideration, the taxability was not in dispute since the taxpayer itself had offered the income to tax.
    - The main business of the parties involved was telecommunication and the transaction involved was to invest in the telecom business. However, in the case under consideration, the taxpayer was in the business of share trading, brokerage etc., and therefore the purchase of shares in ABC JV doing share trading business could not be for the purpose of investment, but only as part of business activity.

    Thus, the aforesaid SC ruling was distinguishable.
  - In the case under consideration, the taxpayer was conducting the business of the joint venture and the consideration received was for premature termination of the joint venture, loss of future profit and renouncement of right to conduct business to A Co. The investment in ABC JV was part of the business of the taxpayer and the investment was done as businessman and not as investor.
  - Further, the valuation of the shares was not based on the net worth but on future business which the taxpayer was losing due to the disinvestment; therefore the gain was a business income.
- Aggrieved, the taxpayer filed an appeal and in the course of appeal proceedings, the matter reached before the Mumbai Bench of the Income-tax Appellate Tribunal (ITAT).

Relevant provisions in brief:

As per section 28(ii) of the ITA, the following income shall be chargeable to income-tax under the head 'profits and gains of business or profession':

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[1] DCIT vs J.M. Financial Ltd. [I.T.A. No.3925/Mum/2015] (Mumbai ITAT)

[2] The Mumbai Bench of the Income-tax Appellate Tribunal (ITAT) had remitted the issue back to the AO for considering the issue of treatment of gain on sale of shares in JV as capital gain or business income in the light of an earlier ruling of the SC viz. Vodafone International Holdings B.V. vs UOI [2012] 341 ITR 1 (SC)

[3] Vodafone International Holdings B.V. vs UOI [2012] 341 ITR 1 (SC)

Any compensation or other payment due to or received by, amongst others:

- any person, by whatever name called, managing the whole or substantially the whole of the affairs of an Indian company, at or in connection with the termination of his management or the modification of the terms and conditions relating thereto;
- any person, by whatever name called, managing the whole or substantially the whole of the affairs in India of any other company, at or in connection with the termination of his office or the modification of the terms and conditions relating thereto;
- any person, by whatever name called, at or in connection with the termination or the modification of the terms and conditions, of any contract relating to his business.

Decision of the ITAT:

The ITAT noted /observed the following:

- The taxpayer held ABC JV shares for more than eight years and the same was reflected under the head investments and not as stock-in-trade in the financials of the taxpayer.
- The taxpayer, during the year under consideration, had earned income mainly from sale of long-term investments, short term investments, interest, lease rent and dividend income from the investment made in ABC JV. Hence, it could not be said that the shares in ABC JV were held by the taxpayer for trading purposes.
- The SC in an earlier ruling[4] had observed the following:
  - According to the look-at test, the task of the Revenue was to ascertain the legal nature of the transaction and, while doing so, it has to look at the entire transaction holistically and not adopt a dissecting approach.
  - In order to find out whether a given transaction evidenced a preordained transaction created for tax avoidance purposes or investment to participate, one has to consider factors, namely, duration of time during which the holding structure existed, the period of business operations in India, generation of taxable revenue in India during the period of business operations in India, the timing of the exit, the continuity of business on such exit, etc.
  - Acquisition of shares may carry the acquisition of controlling interest, which is purely a commercial concept and tax is levied on the transaction, not on its effect.

  In the case under consideration, the taxpayer had sold the investment which the taxpayer was holding for long period of time from which it was earning dividend income. The current transaction, in taxpayer's case, was sale of shares. Thus, applying the above ratio of SC irrespective of whether the taxpayer was having a controlling interest, it was the transaction that needed to be looked into for the purpose of determining the taxability. Accordingly, the shares were held by the taxpayer as investment and the gain arising out of sale of such investment could not be treated as a business income on the grounds that the taxpayer was participating in the business of ABC JV and had transferred the controlling/business interest.
- Further, the consideration for sale of shares was agreed between the taxpayer and A Co as per the agreement of sale of shares in ABC JV. The taxpayer had negotiated the agreed price by producing, before A Co, various prices which were paid in similar transactions and thus arriving at the final price.

[4] Vodafone International Holdings B.V. vs UOI [2012] 341 ITR 1 (SC)

From perusal of the method adopted for valuation of shares by the taxpayer, it was noticed that the taxpayer had agreed for a lump sum consideration without any break-up of what was attributable to assets, liabilities and future business.

- The ITA does not contain provisions to state that determination of the head of income under which the gain on sale of shares is to be taxed is based on the valuation used for arriving at sale consideration for transfer of shares. However, the AO has the right to question the correctness of the valuation and accordingly determine the treatment of the taxability of the amount which in his opinion, is in excess.

  In the case under consideration, the AO did not question the method or basis of the valuation of shares and had not disputed the consideration received towards sale of shares but held the gain to be a business income on the grounds that the valuation was arrived at based on future business.

- The treatment of shares in the books of accounts whether as stock-in-trade or as investment was also one of the determining factors for taxation under capital gain or business income and it could not be said that the method adopted for arriving at the sale consideration determined the nature of transaction.

- Further, since section 50CA was inserted by Finance Act 2017 with effect from 2 April 2018, the said insertion for valuation of capital asset transferred being shares of a company other than equity shares for the purpose of section 48 being 'fair market value' determined as prescribed, was not applicable to the taxpayer for the year under consideration.

- The intention of the taxpayer to hold on to the shares of ABC JV as investment, was demonstrated by the reflection of the shares under investments in the financial statements and from the fact-finding given by the Commissioner of Income-tax (Appeals) that the Board Resolution passed while making the investment, clearly mentioned that the taxpayer had made a capital investment. Accordingly, treatment of the gain as business income on this ground was not sustainable.

In view of the above, the ITAT held that the gain arising on transfer of shares of ABC JV by the taxpayer was chargeable to tax under the head capital gains and the taxpayer was allowed to claim indexed cost of acquisition considering the period of holding of the shares.

Comments:

This ruling has held / upheld the following principles:

- According to the look-at test, the task of the Revenue is to ascertain the legal nature of the transaction and, while doing so, it has to look at the entire transaction holistically and not adopt a dissecting approach.

- Acquisition of shares may carry the acquisition of controlling interest, which is purely a commercial concept and tax is levied on the transaction, not on its effect.

- The ITA does not contain provisions to state that determination of the head of income under which the gain on sale of shares is to be taxed is based on the valuation used for arriving at sale consideration for transfer of shares.

- The treatment of shares in the books of accounts whether as stock-in-trade or investment is one of the determining factors for taxation under capital gain or business income and it cannot be said that the method adopted for arriving at the sale consideration determined the nature of transaction.

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