Tax alert: Long-term capital loss on reduction of share capital, allowable

13 March 2024

The Mumbai Bench of the Income-tax Appellate Tribunal has rendered its decision that reduction of share capital amounts to extinguishment of rights on the shares and is a transfer under section 2(47) of the Income-tax Act, 1961. Hence, even if no consideration is received, the computation provisions under capital gains would apply and loss by way of reduction of capital would be allowable as a long-term capital loss.

In a nutshell

Reduction of equity shares under the scheme of arrangement and restructuring in terms of section 100 of Companies Act, 1956, amounts to extinguishment of rights on the shares. Hence, it is a transfer within the ambit and scope of section 2(47) of the Income-tax Act, 1961.

Where the asset is capable of acquisition at a cost, it would be included in the provisions pertaining to the head 'capital gains' as opposed to assets in the acquisition of which no cost at all can be conceived. If cost can be conceived, then it is chargeable under the head 'capital gains'.

Even when the taxpayer has not received any consideration on reduction of capital but its investment has reduced to loss resulting into capital loss, then while computing the capital gain, capital loss has to be allowed or set-off against any other capital gain.

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Background:

- The taxpayer[1], an Indian company, was a holder of certain number of equity shares of another Indian company (I Co).
- I Co had incurred substantial loss in the course of its business. Hence, a large part of its paid-up share capital was utilised to finance/bear the said loss. In view of such losses, a Scheme of Arrangement and Re-structuring (Scheme) [which was approved by the High Court (HC) of Delhi during the Financial Year (FY) 2008-09, corresponding to Assessment Year (AY) 2009-10] was entered between I Co and its shareholders(one of the major shareholder was the taxpayer). As per the Scheme, amongst others:
  - The paid-up equity share capital of I Co was to be reduced by way of reduction of the number of equity shares of the company.
  - The said reduction of paid-up equity share capital was to be given effect to by reducing the amount from the accumulated debit balance in the Profit & Loss Account and by reduction from Share Premium Account.
  - The reduction was effected as part of scheme under section 100 to 103 of the Companies Act, 1956 (Cos Act).
  - No consideration was payable to the shareholders in respect of the shares which were cancelled.
- As a result of the aforesaid Scheme, the taxpayer's shareholding in I Co reduced to half i.e., equity shares were cancelled as a result of reduction of capital. In the return of income for the FY 2008-09, corresponding to AY 2009-10, the taxpayer claimed long-term capital loss (LTCL) on reduction of share capital (relying on earlier rulings[2]) and had set-off the LTCL against other long-term capital gains.
- During the course of audit proceedings, the Assessing Officer (AO) raised the issue in connection with taxpayer's claim for allowability of LTCL. After examining the submissions both factual and legal in respect of LTCL on reduction of share capital/ cancellation of shares of I Co, the AO accepted the taxpayer's claim for LTCL.
- Thereafter, the Principal Commissioner of Income-tax (PCIT) invoked revisionary proceedings under section 263 of the Income-tax Act, 1961 (ITA) on the same issue, on the following basis:
  - No consideration was received or accrued to the taxpayer as a result of the transfer of shares of I Co therefore, section 48 of the ITA (relating to mode of computation of capital gains) was inapplicable and it was not possible to compute the profits, gains or losses arising from the transfer of the capital asset.
  - The decision[3] of Supreme Court (SC) was distinguishable as it was not a case of reduction in the face value of the shares but an effacement of the entire shares.
  - The Scheme was claimed as scheme of arrangement and restructuring but it was not the Scheme of reduction of capital.
  - There was no extinguishment of rights and the consideration received was nil and not zero. In the facts of the case under consideration, if no consideration was received or accrued to the taxpayer, then, the computation provision under section 48 of the ITA failed.

  Accordingly, the PCIT directed the AO to determine the total income by disallowing LTCL.

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[1] Tata Sons Ltd. vs CIT [ITA No. 3468/Mum/2016] (Mumbai ITAT)

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

[3] Kartikeya Sarabhai vs CIT [1997] 228 ITR 163 (SC)

- Aggrieved, the taxpayer filed an appeal before the Mumbai Bench of the Income-tax Appellate Tribunal (ITAT).

Relevant provisions in brief:

Relevant extract of section 2(47) of the ITA

"(47) "transfer", in relation to a capital asset, includes,…

(i) the sale, exchange, or relinquishment of the asset ; or

(ii) the extinguishment of any rights therein…"

Decision of the ITAT:

The ITAT noted /observed the following:

Whether loss on reduction of share capital is a capital loss?

- The taxpayer had invested in the equity shares and had acquired them at face value of INR 10. Thus, at the time of acquisition of shares, the taxpayer had paid consideration for acquiring the capital asset.
- As per the scheme, book loss and unabsorbed depreciation was written-off first from the balance available in the share premium account and write-off of book losses remaining after deduction against the balance in the share premium account to the amount available from extinguishment of paid-up equity shares. As a result, the shares of the taxpayer reduced to half and the consideration paid on acquisition of capital asset was also reduced to half which resulted into loss to the taxpayer.

Thus, there was a loss on the capital account by way of reduction of capital invested and therefore, any loss on capital account, was a capital loss.

Whether reduction of capital amounts to transfer?

- The SC in an earlier ruling[4] had noted the following:
  - Section 2(47) of the ITA, which is an inclusive definition, *inter alia*, provides that relinquishment of an asset or extinguishment of any right therein amounts to a transfer of a capital asset. While the taxpayer continues to remain a shareholder of the company even with the reduction of share capital, it could not be accepted that there was no extinguishment of any part of his right as a shareholder qua the company.
  - A company under section 100(1)(c) of the Cos Act has a right to reduce the share capital and one of the modes which could be adopted is to reduce the face value of the preference share.
  - When as a result of the reducing of the face value of the share, the share capital was reduced, the right of the preference shareholder to the dividend or his share capital and the right to share in the distribution of the net assets upon liquidation was extinguished proportionately to the extent of reduction in the capital. Such reduction of the right of the capital asset clearly amounted to a transfer within the meaning of section 2(47) of the ITA.
- Reliance was also placed on:
  - The decision[5] of the Karnataka HC wherein it held that consequent to taxpayer's default in not paying the balance of money on allotment, its rights in the shares stood extinguished on forfeiture and the loss suffered by the taxpayer (i.e., non-recovery of share application money) was consequent to the forfeiture of its rights in the shares. The same was to be understood to be within the scope and ambit of transfer and therefore, it amounted to short-term capital loss to the taxpayer.

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[4] Kartikeya Sarabhai vs. CIT [1997] 228 ITR 163 (SC)

[5] DCIT vs. BPL Sanyo Finance Ltd. [2009] 312 ITR 63 (KAR)

- The SC decision[6] wherein it was held that the right of the taxpayer in the capital asset stood extinguished either upon amalgamation or by reduction of shares it amounted to transfer within the meaning of section 2(47) of the ITA and therefore, computation of capital gains had to be made.

Therefore, reduction of equity shares under the scheme of arrangement and restructuring in terms of section 100 of Cos Act, amounted to extinguishment of rights in the shares. Hence, it was a transfer within the ambit and scope of section 2(47) of the ITA.

Whether consideration is conceivable and if yes, whether section 48 of the ITA applied in case there was no actual receipt?

- The reduction of capital has been provided under section 100(1) of the Cos Act and it provides for the manner in which reduction of capital can be effected. It envisages to pay for any paid-up capital which is in excess with the wants of the company. Thus, there is a consideration envisaged in the reduction of the capital. There could be a case where consideration is paid on the reduction of capital or consideration is not paid at all.
- The SC in earlier rulings[7] had observed that where an asset which was capable of acquisition at a cost would be included within the provisions pertaining to the head 'capital gains' as opposed to assets in the acquisition of which no cost at all could be conceived. If cost could be conceived, then it was chargeable under the head 'capital gains'.
- The Gujarat HC in an earlier ruling[8] had observed the following:
  - The contention of the Revenue that the provision of capital gain should apply to actual receipts only could not be accepted because it would result into incongruous and anomalous results as in case even where negligible or insignificant sum was received, it would result in computation of capital gain or loss but in case where nothing was disbursed or received on extinguishment of rights, it would not result into loss.
  - Even where there is a 'nil' receipt of the capital, the entire extinguishment of rights had to be written off as a loss resulting from computation of capital gains.
  - Thus, once a conclusion was reached that extinguishment of rights in shares was deemed to be transfer for operation of section 46(2) read with section 48 of the ITA, it was reasonable to carry that legal fiction to its logical conclusion to make it applicable in all cases of extinguishment of such rights, whether as a result of some receipt or nil receipt.
- The ratio of the Gujarat HC was applicable on the facts of the case under consideration because there could be no distinction where taxpayer receives some negligible or insignificant consideration and where taxpayer had received 'nil' consideration.

Conclusion:

- In the case under consideration, the reduction of capital is extinguishment of right on the shares and it amounted to transfer within the meaning and scope of section 2(47) of the ITA.
- The loss on reduction of shares was a capital loss and not notional loss.
- Even when the taxpayer had not received any consideration on reduction of capital but its investment had reduced to loss resulting into capital loss, then while computing the capital gain, capital loss had to be allowed or set-off against any other capital gain.

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[6] CIT vs. Grace Collis and Others [2001] 248 ITR 323 (SC)

[7] CIT vs. D.P. Sandhu Brothers Chembur Pvt. Ltd. [2005] 273 ITR 1 (SC) and CIT v. B.C. Srinivasa Setty [1981] 128 ITR 294/ 5 Taxman 1 (SC)

[8] CIT vs. Jaykrishna Harivallabhdas [1998] 231 ITR 108 (Gujarat HC)

In view of the above, the ITAT held that AO had rightly allowed the computation of LTCL to be set-off against the capital gain as shown by the taxpayer and consequently, the revisionary order of the PCIT was set aside.

Comments:

Taxability on account of reduction of share capital and treatment of loss arising therefrom on such reduction (where there is no receipt of consideration on reduction of share capital) has been a subject matter of litigation. Further, it may be pertinent to note that the reduction of share capital, amongst others, could be by way of reduction in the face value of shares, reduction in the number of shares.

There are diverse views taken by different courts and the same have been considered in the current ruling. The ruling in the current case (which related to revisionary proceedings initiated by the PCIT against the AO's order) has held / upheld as follows:

- Reduction of equity shares under the scheme of arrangement and restructuring in terms of section 100 of Cos Act, amounts to extinguishment of rights on the shares and hence, it is a transfer within the ambit and scope of section 2(47) of the ITA.
- Where the asset is capable of acquisition at a cost, it would be included in the provisions pertaining to the head 'capital gains' as opposed to assets in the acquisition of which no cost at all can be conceived. If cost can be conceived, then it is chargeable under the head 'capital gains'.
- Even when the taxpayer has not received any consideration on reduction of capital but its investment has reduced to loss resulting into capital loss, then while computing the capital gain, capital loss has to be allowed or set-off against any other capital gain.

The ruling has also distinguished the decision of the Mumbai Special Bench of the ITAT in case of Bennett Coleman & Co. Ltd. v. ACIT [2011] 14 taxmann.com 1 (Mumbai) on the basis that it was a case of substitution of shares. However, it also noted / observed that:

- The ratio of majority judgement could have been interpreted against the taxpayer in present case as it clearly held that reduction of shares, where no consideration is received, the computation of capital gains/loss cannot be made, even though facts were different in that case.
- It did not rely upon the minority judgement but the case under consideration was under revisionary jurisdiction under section 263 of the ITA wherein the PCIT had cancelled the AO's order who had accepted the LTCL. The dissenting judgement showed that it was a possible view (reduction was allowable as loss was a possible view). Therefore, if a view was taken by the AO in favour of the taxpayer, then it could not be held that the AO's order was erroneous and therefore, could be set aside or cancelled.

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