

# kcmFlash

Income Tax

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## Capital reduction results in extinguishment of right in shares, loss arising thereon on account of 'Nil' consideration allowable as 'capital loss'

### Snapshot

Mumbai ITAT has held that cancellation of shares pursuant to scheme of capital reduction leads to extinguishment of rights in capital assets, thus tantamount to 'transfer' as defined u/s 2(47) of the IT Act and that computation of capital loss was a logical consequence of such transfer of capital asset.

On capital reduction without consideration, the ITAT held that computation mechanism u/s 48 of the IT Act would apply and would not fail where consideration is conceivable and ascertained to be Nil and allows set off of long-term capital loss arising on capital reduction in computation of total income of the Taxpayer.

### Facts of the Case

Tata Sons Ltd. (Taxpayer) held over 2.88 billion shares in Tata TeleServices Ltd (TTSL), out of which, 1.44 billion equity shares were cancelled pursuant to scheme of arrangement u/s 100 and 391 of the then Companies Act, 1956, approved by Delhi High Court. Loss arising on capital reduction was claimed as long-term capital loss and set off against long term capital gains arising from other transactions. During the course of scrutiny assessment, assessing officer raised issues and examined details and submissions and accepted Taxpayer's claim for allowability of such long-term capital loss.

PCIT however passed revisionary order u/s 263 of the IT Act holding that the order passed by AO was erroneous and that capital loss on cancellation of shares should not be allowed on account of various reasons such as: (a) such loss was only notional in nature, (b) Section 48 of IT Act required deduction of costs from full value of consideration for computation of capital gains and that where no consideration was received or accrued to the Taxpayer, the computation provisions u/s 48 of the IT Act failed, (c) As distribution of surplus by issuance of bonus shares is not taxable, adjustment to or utilization of losses by way of reduction of capital should not be allowable as deduction, (d) The AO in the case of another taxpayer, Tata Power Ltd, had disallowed loss arising on reduction of share capital of TTSL and the AO did not consider the same issue for the same year in the case of Taxpayer, which in view of the PCIT was a mistake which has resulted in loss to revenue.

### Taxpayer's Appeal

The Taxpayer contended that the reduction of share capital, with reduction in number of shares and without consideration was in accordance with provisions of the Indian Companies Act and tantamount to transfer as there was relinquishment of assets and extinguishment of rights therein.

It was contended that considering that Section 55(2)(b)(v) which provides for the cost of shares of a company which become the property on happening of specific events mentioned therein, does not include cancellation of shares on reduction of capital, it would not be possible to add cost of shares cancelled to the cost of balance shares held which are not cancelled on account of capital reduction. Taxpayer thus contended that cost of the cancelled shares if not allowed in the year of capital reduction, would not be allowed in future also and would be a permanent loss.

Relying on various judicial decisions, Taxpayer contended that the claim for capital loss should have been allowed and that once the AO had after considered facts, and various propositions of law and judicial decisions allowed long term capital loss, PCIT could not take a different view holding that the view of the AO was incorrect.

### Revenue's Contentions

Revenue authorities rejected Taxpayer's reliance on Kartikeya Sarabhal 228 ITR 163 SC, to substantiate its claim that reduction of right in the capital asset would amount to a transfer within the meaning of that expression in section 2(47), citing that there was no reduction in face value of the shares in the present case and that cancellation of shares or effacement of the shares was only an arrangement pursuant to a scheme of arrangement and restructuring between the Company and its shareholders and creditors and not a scheme of reduction of share capital.

The order of the PCIT also stated that where pursuant to the scheme shares got extinct, corresponding rights

therein also got extinct and where upon cancellation shares did not exist, rights also did not exist and hence there could not be any extinguishment of such extinct rights and thus there could not be any transfer.

Revenue contended that even if it tantamount to transfer u/s. 2(47), then also the computation mechanism u/s 45 read with Section 48 of the IT Act failed because no consideration was received by or accrued to the Taxpayer. Further, revenue authorities placed reliance on the decision of Bennett Coleman and Co. Ltd. Vs. Addl. CIT 2011(9) TMI-ITAT, Mumbai, Special Bench, wherein loss on capital reduction followed by consolidation of share was held as notional and was disallowed by the majority view holding that substitution of shares of one kind with another did not amount to transfer.

### Decision of ITAT

#### On whether capital reduction tantamount to 'transfer'?

- The ITAT held that right of Taxpayer in a capital asset gets extinguished on account of capital reduction and the same should be treated as a transfer within the meaning and expression of Section 2(47).
- In this regard, the ITAT relied on the decision of the Supreme Court in the case of Kartikeya Sarabhai reported in 228 ITR 163 (SC), where, on reduction of face value of shares, it was held that there was a reduction in dividend and liquidation rights of shareholders qua company and such proportionate extinguishment of rights tantamount to transfer u/s 2(47) of the Act.
- The ITAT also relied on the decisions of Mrs. Grace Collis 248 ITR 323 (SC) on cancellation of shares pursuant to amalgamation and in case of BPL Sanyo Finance Ltd. 312 ITR 63 (Kar HC) in context of loss on account of non-recovery of share application money on forfeiture of rights in

shares and held that the definition of 'transfer' in section 2(47) contemplates the extinguishment of rights in a capital asset distinct and independent of such extinguishment consequent upon or otherwise than on account of transfer of such capital asset.

### **On actual vis-à-vis notional loss**

The ITAT held that Taxpayer had acquired shares for a cost and that loss on reduction of share capital was a capital loss and not a notional loss.

### **On computation mechanism of Section 45 read with Section 48**

- The ITAT held that computation of capital gains as per provisions of Section 45 read with Section 48 should be made where there was a transfer of capital asset
- It was held that where an asset is capable of being acquired at a cost and where it is possible to envisage cost and consideration of such asset, computation under the head 'capital gains' should be made. Only where a capital asset cost or consideration is indeterminable or cannot be conceived, the computation mechanism under Section 48 would fail.
- ITAT held that the capital asset was acquired by Taxpayer at an identified cost and consideration in the present case was also conceivable and was 'Nil'. ITAT also held that if some nominal consideration was provided upon capital reduction, capital loss would have been computed u/s 48 and that it would not be logical if loss is allowed in case of 'nominal consideration' and disallowed in case of 'nil' consideration and computation of capital loss was thus to be made as per the provisions of Section 45 read with Section 48 in the present case. ITAT also relied on the decision of Gujarat High Court in the case of Jaykrishna Harivallabhdas 231 ITR 108, wherein, pursuant to liquidation the shareholder had not received any

liquidation proceed an entire cost of acquisition of shares was allowed as capital loss.

### **Distinguished the decision in the case of Bennett Coleman & Co. Ltd.**

- The ITAT distinguished the decision of Mumbai ITAT Special Bench in the case of Bennett Coleman wherein capital reduction was undertaken by way of reduction of paid up value of shares followed by consolidation of shares and relied on the decision in the case of Carestream Health INC vs. DCIT (2020) (ITA No. 826/Mum/2016) for drawing such distinction.

The ITAT thus held that even when Taxpayer did not receive any consideration on reduction of capital but its investment were reduced resulting into capital loss, such capital loss had to be allowed or set-off against any other capital gain and quashed the revisionary order passed by PCIT restoring order passed by AO, in favour of Taxpayer.

### KCM Comments

In general, amounts distributed to shareholders on reduction of share capital over and above accumulated profits and in excess of original cost of acquisition of shares are chargeable to capital gains tax in the hands of the shareholders. Taxability of gains as capital gains in case of capital reduction with payments (or with distribution of assets) has been upheld by various judicial precedents such as in the case of G. Narasimhan [1999] 236 ITR 327 (SC).

While taxability of capital reduction involving payments to shareholders is quite a settled position, taxability of capital reduction without any payment to shareholder in loss scenario has been a matter of debate with judicial precedents on both sides.

This case provides clarity on capital reduction by loss making entities involving reduction in number of shares. The question that still remains open is when provision of Companies Act permits reduction in share capital by way or reduction in number of shares or paid

up capital, and where in substance loss arises even in case of capital reduction by way of reduction in paid up value of the shares, can principles of the decision in case of Tata Sons be applied in case of capital reduction by way of reduction in paid up capital and would it be possible to distinguish decision in the case of Bennett Coleman & Co. Ltd.

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*For further analysis and discussion, you may please reach out to us.*

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