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Corporate Tax

Loss on Sale of Investments

Business Loss or Capital Loss?

June 12, 2020

Snapshot

Delhi ITAT has recently ruled on the principle of whether losses arising on account of disposal of investments should be classified as Business Loss or Capital Loss. The key principles that emerge out of the two judgments are:

a. When investments are inextricably linked to and are forming part of business, loss arising on account of transfer of such investments could be considered as "business loss";
b. Whether or not investments are inextricably linked to and are a forming part of business, is a very factual exercise, and will depend upon the nature of business undertaken by the Taxpayer and the manner in which the investment is linked to the business;
c. Once the above principle is satisfied, mere nomenclature used in the financial statements would not change the character of the loss

These judgments reiterate the position upheld by multiple Courts as regards relevance of an inextricable linkage between business and investments. Interestingly, in both the judgments, the Benches have neither dealt with the concept of "capital asset" nor considered CBDT Circular No. 4/2007 that provides for principles for taxability by differentiating between shares held as investments and those held as stock-in-trade.

In case Taxpayers are desirous of taking a position relying upon these judgments, they should undertake a factual exercise to establish clear linkage between the business and investments after factoring other possible implications.

Background and Coverage

Recently, in a span of mere two days, Delhi Bench of ITAT has pronounced two judgments[1] around a common issue viz. allowability of losses from sale of or write off of investments under the Income-tax Act, 1961 ('the Act'), *albeit*, on completely different facts. Over the years, there have been rising litigation on the issue, especially, as Taxpayers have been claiming such losses on disposal (by transfer or otherwise) of investments as "business losses".

While in the case of Anant Raj Limited (supra), the Delhi Bench has clearly established the fact of investments being an integral part of the business, thereby allowing loss on account of non-recoverability pursuant to transfer, as Bad Debts; in the case of National Research Development Corporation (NRDC), the Delhi Bench has established that the investments were not connected with the business of the Taxpayer and accordingly, ruled that the loss on account of past diminution in value of investments is non-tax deductible, being capital in nature and not pertaining to the year under consideration.

We have provided case-specific analysis of both the judgments in **Appendix A (**Anant Raj Limited) and **Appendix B (**National Research Development Corporation).

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[1] ***Anant Raj Ltd v. ACIT & ACIT v. Anant Raj Ltd*** *(ITA No. 5169/Del/2017 and ITA No. 5677/Del/2017) and* ***National Research Development Corporation (NRDC) v. DCIT*** *(ITA No. 147/Del/2017)*

Jurisprudence thus far

There have been many judgments wherein the aforesaid issue was taken up for consideration.

Rajasthan HC in the case of **Rajasthan Financial Corporation v. CIT [1967] 65 ITR 112** had allowed the claim of loss on sale of investments as "Business loss" notwithstanding the fact that investments were not being shown as Stock-in-trade, considering that investments made by the Taxpayer was closely linked to the business of the Taxpayer. In that case, the Taxpayer was in the business of arranging for finance for various industries and in the process had made investments in Government securities so as to realise funds in times of need.

Ahmedabad Bench of ITAT in the case of **DCIT v. Gujarat Small Industries Corporation [2004] 84 TTJ 22** had also allowed the claim of Taxpayer of a loss as "business loss". In that case, the Taxpayer (a Government Corporation) was engaged in the business of promoting small industrial units and on their being self-sufficient, to sell them off. Accordingly, the investment was treated as a Trading Investment. Ahmedabad Bench had, therefore, held that the loss was closely linked to the business of the Taxpayer and hence allowable as a "business loss".

A well celebrated judgment is that of the **Bombay HC** in the case of **CIT v. Colgate Palmolive (India) Limited [2015] 370 ITR 728** wherein HC allowed claim of loss on sale of shares of a wholly owned subsidiary as a "business loss" as the main reason for setting up the subsidiary was to manufacture tooth brushes exclusively for the Taxpayer and since Taxpayer was relying upon the subsidiary for manufacturing of toothbrush to be traded by the Taxpayer, investment was nothing but a measure of commercial expediency to further business objectives. SLP filed by Revenue against the judgment has been dismissed by **Supreme Court**.

Relying upon Bombay HC judgment in the case of Colgate Palmolive (supra), **Delhi Bench** of ITAT in the case of **Sahara Global Vision Pvt. Ltd. v. ACIT [ITA No. 2514/Del/2014]** allowed a write off of loss of investment in a JV pursuant to the JV getting liquidated as the investment in JVs were made in furtherance of the objects of the Taxpayer to carry out the same line of business in the USA.

Similarly, **Delhi Bench** of ITAT in the case of **Cosmos Industries Limited v. DCIT [ITA No. 3730/Del/2015]** had allowed claim of loss on sale of shares of subsidiaries set up as Special Purpose Vehicles (SPV) as "business loss" considering that the SPV were set up for carrying out the business of generation of power and real estate but could not function and hence, investment therein had to be sold off at a loss.

The bottom line that evolves from all of the judgments is that, investment should be inextricably linked to the business of the taxpayer for putting forth a claim that the loss arising from sale / write off thereof should be treated as "business loss". To Taxpayers' delight, in all these cases, the judgments have been held in the favour based on facts, once the inextricable linkage between business and investments was established.

A Different Perspective

It is important to note that the term "capital asset" has been defined under section 2(14) of the Act so as to categorically mean ***property of any kind held*** by an assessee, ***whether or not connected with his business or profession***. Thus, even if a property (say, investment in shares) is "connected with business", it would ideally fall within the purview of a "capital asset". The definition of capital asset specifically excludes ***stock-in-trade held for the purposes of business or profession***. Accordingly, ideally speaking, any property (including shares) that is not stock-in-trade for business should fall within the purview of "capital asset" and, any property (including shares) that is held as stock-in-trade should ideally not be considered as "capital assets" and hence loss from sale thereof should qualify as "business loss".

CBDT *vide* Circular No. 4/2007 dated 15 June 2007 laid down certain principles in order to distinguish between shares held as investments ("Capital Asset") and shares held as stock-in-trade ("Trading Asset") and also clarified that Trading Asset is dealt with by section 28 of the Act (which deals with Business Profits) whereas Capital Asset is dealt with by Sections 2(14)/2(29A)/2(29B) of the Act (which deals with Capital Gains).

What flows from the Circular is, if the investment is proved to be stock-in-trade, income or loss therefore is to be treated as Business Income / Loss. While, as a principle, CBDT Circular may not be binding on the Taxpayers, it is important to note that the Circular does not provide for anything more than what is mandated by the provisions of the Act and in our view, it merely reiterates the provisions of the Act discussed above.

Interestingly, none of the above judgments have discussed at length, the definition and meaning of "capital asset" so as to check if the shares were "capital assets" or not, except that the judgments of Ahmedabad Bench in the case of Gujarat Small Industries Corporation (supra) and Anant Raj Limited (supra and infra) have in-principle followed the meaning (without referring to the same) whereby based on facts, it has been held that the investments were trading investments (*akin* to stock-in-trade) and hence, loss arising from sale thereof was "business loss".

In the context of loan (and not shares), **Mumbai ITAT Bench** had, in the case of **Siemens Nixdorf Information Systemse GmbH vs. DDIT (International Tax) [ITA no. 3833/Mum/2011]**, held that a "loan" given by a foreign company to a wholly owned subsidiary in India should be considered as a "capital asset", after examining the definition of "capital asset" in detail and accordingly held that loss arising from transfer thereof (due to winding up of Indian subsidiary) should be allowed as a "capital loss". Bombay HC has upheld the order of the ITAT observing that the Revenue was not able to show whether the loan was falling within any of the exclusions provided in section 2(14) so as to take it out of the definition of "capital asset".

Revenue has filed a SLP with the Supreme Court against the HC judgment and the Supreme Court would now determine whether the loan can be regarded as 'capital asset' or not. While this case deals with a loan, the principles of the HC judgment may be relevant, especially in connection with what would / would not get covered by the definition of "capital asset".

Word of caution

A very important point to note here is that, all the judgments discussed herein above were related to situations wherein taxpayers had sustained a loss on sale of investments, which was claimed as a tax- deductible business loss. From this perspective, it would be interesting to see if the tax authorities rely upon the same judgments to contend that profits arising out of sale of shares which are inextricably linked to business should be taxed as "Business Profits" and not "Capital Gains". This issue could open a Pandora's Box because, in the situation of profits, it could have far reaching implications, for example, no benefit of indexation, higher tax on account of difference in tax rates in certain cases, etc.

Concluding thoughts

Claiming losses on account of sale of shares as "business loss" continues to remain a debatable issue and more importantly, an extremely fact driven exercise and position.

In the process, a proper evaluation of inextricable linkage between investments and business should be carried out. Taxpayers should take a conscious call of claiming loss from sale of investments as "business loss" by relying upon the aforesaid judgments, only after factoring the other possible implications / perspective discussed above.

Should you need more information, kindly reach out to

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Appendix A

Anant Raj Ltd v. ACIT and ACIT v. Anant Raj Ltd (ITA No. 5169/Del/2017 and ITA No. 5677/Del/2017)

Loss due to write off of receivable on sale of investments, income from which was earlier offered to tax as "Capital Gains" is not a Capital Loss but allowable as Bad Debts under section 36(1)(vii) as the investments were a routine part of business of the taxpayer. The ITAT further held that merely classification of income as "Capital Gains" in the past does not disentitle the taxpayer to claim the loss / deduction under correct head in subsequent year.

Facts

- Taxpayer was a public limited company engaged in business of real estate (construction and development) along with subsidiary companies
- It was also engaged in obtaining permissions for Change Land Use ('CLUs') and other development permissions from Government and local authorities
- As per Regulations, a minimum limit (50 acres) was prescribed for developing a Township, however a single entity could not hold land beyond a particular limit (17.95 acres)
- In order to fulfil the regulations, plots were acquired by the Taxpayer along with subsidiary companies, who thereafter transferred the Development Rights to the Taxpayer
- Income earned from development of plots of land was categorised as "Business Income"
- Investments made in subsidiary companies were shows as "long term investments" under Companies Act because of requirement of law, however the purpose of investment was to acquire land as a part of its business and hence, in effect, such investments were "business investments"
- In respect of a particular deal, the Taxpayer was to sell the plots of land by way of transfer of shares of a subsidiary which held the plots and also obtain CLUs. The total consideration for both the above activities was fixed at INR 93 crore out of which only 15 crore was paid at the time of agreement. However, the full amount was considered for tax purpose and profit of INR 72 crore was offered to tax as Long Term Capital Gains taxable @ 20% in AY 2010-11.
- Post this due to Government orders, the land was acquired by the Government and the Taxpayer could not obtain the CLU nor could it go ahead with the deal. Accordingly, the Taxpayer wrote off the amount of INR 78 crore (balance receivable) as bad debts in AY 2013-14 and claimed deduction u/s 36(1)(vii) rws 36(2).
- This claim was not allowed by the lower authorities considering that the loss was to be claimed under "Capital Gains" as it was capital in nature resulting from investments that are capital in nature coupled with the fact that the Taxpayer had shown income as "Capital Gains" in the prior year.

Taxpayer's Contentions

- Income earned from activities undertaken during normal course of business is to be treated as "business income"
- Substance of the transaction is to be seen than the form

- Merely because the Taxpayer had wrongly treated the income as "Capital Gains" in earlier year should not disentitle it from claiming the same as "business income" / "business loss" in subsequent year and AO is duty bound to assess income correctly
- As necessary clearances could not be obtained by the Taxpayer due to certain factors, non-receipt of income should be treated as "bad debts" or "business loss" allowable under the Act

Revenue's Contentions

- Departmental Representative relied upon the observations by AO / CIT(A)
- It was argued that the Taxpayer had itself showed the income as "Capital Gains" treating the transaction as capital in nature and hence, character cannot be changed
- Further, it was also brought on record that no business income was shown in the year of agreement / initial recognition of income
- Income that was offered to tax by Taxpayer in earlier year was taxed @ 20% as Capital Gains and not 30% as Business Income
- Accordingly, it was contended that the claim should not be allowed as Bad Debts.

ITAT's observations and Ruling

- The substance of transaction of shares was the sale of underlying asset viz. land and the services of CLU made the asset more valuable
- Profit was mainly because of the services in connection with CLU and other clearances
- The same should ideally be assessed as "Business Income"
- Merely because a taxpayer has offered income any other head either by mistake or under an erroneous presumption, it does not become an estoppel to point out that the same was assessable under a different head correctly
- Taxpayer can always point out in a subsequent year in which it is claiming deduction or loss that income offered in earlier years was not shown under the correct head
- Fact that declaration and assessment of corresponding income has been assessed as capital gains and accepted in earlier year will not bind the Taxpayer
- Claim of income or loss or deduction is to be examined afresh in the year of claim
- Relying upon certain judgments and pursuant to provisions, it can be said that Taxpayer need not prove that debt has become irrecoverable. Further, the Law does not require the bad debt has to accrue out of income under the same head "Income from Business or Profession" to be tax deductible
- Taxpayer had incurred genuine loss of Rs. 78 crore and hence, there should not be an injustice to the taxpayer as it had already paid taxes on hypothetical income as "Capital Gains"
- Claim of bad debts is to be allowed as a revenue business loss without disturbing the earlier assessment which has attained finality.

Appendix B

National Research Development Corporation (NRDC) v. DCIT (ITA No. 147/Del/2017)

Loss due to write off of investments on account of permanent diminution in value of such investments that were not akin to the business of the Taxpayer would be categorised as loss on capital account and would not be tax deductible business loss, especially when the loss did not arise on account of transfer of shares of a subsidiary but merely as a result of a book entry (permanent diminution) and the loss had arisen in the past years, not in the year under consideration.

Facts

- Taxpayer was a public limited company formed by Ministry of Science and Technology, involved in development, promotion, and commercialisation of technologies
- Taxpayer had written off an amount of Rs. 60 lakh in respect of equity investments in Twenty First Century Battery Limited (CBL) in the earlier years. CBL was engaged in manufacturing of Lithium Ion Batteries
- The amounts invested were shown as "investment" in the Balance Sheet
- Assets of CBL were sold off by lending institutions under SARFAESI Act and hence there was no scope of recoverability
- Accordingly, the amount of investment was written off in the books of account
- AO treated the same as a capital loss, not allowable under the Act

Taxpayer's contentions

- Object of the company covers investment in other companies if such investments are likely to promote further or benefit the business or interest of the company.
- As per agreement between the Taxpayer and CBL, Taxpayer had participated in equity of CBL as a co-promoter
- Under SARFAESI Act, CBL's assets have been sold
- There is a permanent diminution in value of investments and hence, the same is written off during the year
- The said write off is a deductible business loss and not capital loss
- Reliance was placed by the Taxpayer upon the judgments in the case of DCIT v. Gujarat Small Industries Corporation [2004] 84 TTJ 22 (Ahmedabad ITAT) and CIT v. Colgate Palmolive Ltd [370 ITR 728] (Bombay HC)

Revenue's contentions

- Investment made by the Taxpayer was a capital investment
- There was no transfer of shares during the year but a mere write off of investments
- Permanent diminution in value of investments is merely an accounting entry
- It was not the business of the Taxpayer to make investments in such companies (MOA provided for investment in like object entities)
- Accordingly, the loss was capital in nature and not tax deductible

ITAT's Observations and Ruling

- Investment in CBL did not qualify as an Object in Clause 5 of MOA
- The investments were written off as CBL went into liquidation and all assets were sold, thereby investments lost all its value
- Investments were shown as "Unquoted Trade Investments"
- Taxpayer had disclosed in its Notes to Accounts that the Taxpayer had invested the sum and the unit was closed since long.
- Financial Institution (IDBI) intimated the Taxpayer that no amount was due to it and hence such investment was written off under "Other Expenses"
- The loss was merely an accounting loss and was relating to "investment" which was invested as "capital asset"
- Permanent diminution in value of investment can only happen in long term investments
- CBL was closed since long back and in any case, the loss was pertaining to earlier years and did not qualify as tax deductible for the year under consideration
- Judgments relied upon by the Taxpayers are distinguishable as they pertain to cases of transfer of shares (Trade Investment / Business Investment)
- Ground of appeal was accordingly dismissed and order of lower authorities to treat the loss as non-deductible capital in nature was sustained

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