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EY Tax Alert

Mumbai ITAT rules redemption of preference shares not taxable as deemed dividend



Executive summary

This Tax Alert summarizes a recent ruling of the Mumbai Income Tax Appellate Tribunal (ITAT) [ITA Nos. 5318 & 5319/Mum/2006] in the case of Parle Biscuits Pvt. Ltd. (Taxpayer) on the issue of taxability of amounts received on redemption of preference shares under the Indian Tax Laws (ITL). The ITAT held that amounts received on redemption of preference shares cannot be taxed as 'deemed dividend' since it does not arise on account of reduction of capital and it amounts to 'transfer' of a capital asset which is subject to capital gains under the ITL.

Facts

- ▶ Under the ITL, the definition of dividend includes, *inter alia*, any distribution to the shareholders of a company on reduction of its capital to the extent the company possesses accumulated profits (deemed dividend). Deemed dividend provisions exclude distribution on reduction with respect to non-participating shares issued for full cash consideration.
- ▶ The Taxpayer is an Indian company engaged in the business of manufacturing of biscuits. It had invested in the preference shares of two Indian companies in 1995. The preference shares were redeemed at par in 1997.
- ▶ The Taxpayer treated redemption of the preference shares to be transfer under the ITL and claimed indexation benefits on the cost of

acquisition of the preference shares. Accordingly, the long-term capital loss was calculated by reducing indexed cost from redemption proceeds.

- ▶ The Tax Authority disallowed the claim of capital loss. Relying on the decision of the Supreme Court (SC) in the case of *G. Narasimham & Others*^[1], the Tax Authority was of the view that the entire consideration received on redemption of preference shares had to be treated as deemed dividend under the ITL.
- ▶ The Taxpayer appealed to the first appellate authority which ruled in favor of the Tax Authority. The Taxpayer, thereafter, appealed to the ITAT against the above order.

Taxpayer's contentions

- ▶ In terms of the Indian Company Law (ICL) provisions, redemption of preference shares cannot be treated as reduction of share capital of a company.
- ▶ The preference shares were non-participating preference shares subscribed in cash and redemption was, therefore, specifically excluded from the scope of deemed dividend.

^[1] [236 ITR 327]

- ▶ Reliance was also placed on the decision of the SC in the cases of *Anarkali Sarabhai*^[2] and *Kartikeya Sarabhai*^[3] to support that redemption of preference shares amounts to transfer under the ITL.
- ▶ Reliance was placed on the Bombay High Court (Bombay HC) decision of *Surat Cotton Spinning and Weaving Mills*^[4] to contend that claim of capital loss, consequent to redemption, should be allowed.

ITAT's ruling

On 'deemed dividend' under the ITL

- ▶ In the case of *G. Narasimham (supra)*, the SC held that the amount distributed by a company on reduction of share capital has two components; one attributable to accumulated profits and the other to capital. The part attributable to accumulated profits was taxable as deemed dividend and the balance may be subject to tax as capital gains under the ITL.
- ▶ Under the provisions of the ICL, redemption of preference shares cannot be considered as reduction of share capital. In view of the above, consideration received on such redemption of preference shares cannot be treated as deemed

^[2] [224 ITR 422]

^[3] [229 ITR 163]

^[4] [202 ITR 932]

dividend arising as a result of distribution on reduction, even when it is paid out of the accumulated profits of the company.

- ▶ It cannot be accepted that the entire redemption of preference share resulted in deemed dividend and, hence, the sale consideration for capital gains would be nil. If such a suggestion is made, the entire cost of acquisition would be capital loss which would entitle the Taxpayer to claim a higher loss. The Bombay HC, in the case of Surat Cotton Spinning and Weaving Mills (*supra*), supports that, to avoid double taxation, a part of the consideration which is considered as dividend needs to be excluded for calculation of capital gains.

On 'transfer' under the ITL

- ▶ The SC decision in the case of Anarkali Sarabhai (*supra*) supports the view that redemption of preference shares has the effect of sale of such shares as the company pays the value of the shares to the preference shareholders and takes back such shares. Redemption of preference shares by a company is in the nature of relinquishment and it squarely comes within the definition of transfer under the ITL.
- ▶ Reliance was also placed on the SC decision in the case of Kartikeya Sarabhai (*supra*) wherein it was held that, on reduction of face value of shares, the right of the preference shareholder (with regard to dividends and share in the distribution upon liquidation) was extinguished proportionately. Such reduction of the right in the

capital asset would clearly amount to transfer of the capital asset under the ITL.

- ▶ Hence, redemption of preference shares has to be considered as transfer under the ITL.
- ▶ By virtue of the computation mechanism provided under the ITL, the amount calculated by the Taxpayer, after taking indexation benefits etc., is an allowable long-term capital loss.

Comments

Taxability of redemption of preference shares as deemed dividend or capital gains has not been free from doubt. The present ruling provides clarity on the issue with regard to redemption of non-participating preference shares at par. The ITAT holds that the consideration received would not be deemed dividend and redemption cannot be regarded as an event of reduction of capital.

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