

EY Tax Alert

SC dismisses SLP to hold that capital reduction leads to transfer of shares and exigible to capital gains taxation

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Executive summary

This Tax Alert summarizes a ruling of the Supreme Court (SC) in the case of Jupiter Capital Pvt. Ltd.¹ (Taxpayer) which dismissed the petition filed by the Tax Authority against admissibility of capital loss arising in the hands of shareholders on cancellation of equity shares held in subsidiary company pursuant to a scheme of capital reduction. In other words, the issue under consideration was whether capital reduction by a company amounts to “transfer” under the Indian Tax Laws (ITL) in the hands of the Taxpayer-shareholder and, accordingly, whether the Taxpayer can claim capital loss, if any, pursuant to the same.

In facts of the case, the Taxpayer held 99.98% equity shares of an Indian Company (I Co). I Co undertook cancellation of equity shares held by the Taxpayer under a scheme of capital reduction in lieu of monetary consideration apart from cancelling lost capital due to losses. Accordingly, the Taxpayer’s holding in company was reduced from approximately 153.34 million shares to 9,998 shares with total post reduction shareholding remaining unchanged at 99.98%. The issue arose on admissibility of capital loss in the hands of Taxpayer on cancellation of such shares under provisions of the ITL. While the Tax Authority denied claim of capital loss in hands of the Taxpayer, the Bangalore Income-tax Appellate Tribunal (Tribunal) allowed the claim of capital loss. On appeal to Karnataka High Court (HC), the order of Tribunal was upheld.

The SC dismissed the special leave petition (SLP) filed by Tax Authority against HC’s order. Basis a series of settled judicial precedents, particularly, the ratio laid down by the SC in the case of Karthikeya V Sarabhai vs. CIT², it held that cancellation of equity shares by subsidiary company results in “transfer” under the provisions of the ITL as there is extinguishment of rights qua such shares. The SC held that capital loss arising on proportionate reduction in share capital of I Co is admissible even if the overall shareholding of the Taxpayer in I Co remains unchanged post reduction.

¹ PCIT vs. Jupiter Capital Pvt. Ltd. (TS-09-SC-2025) dated 2 January 2025

² [1997] 228 ITR 163



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Background

- ▶ The taxation under the scheme of arrangement of capital reduction is governed by general provisions of the ITL. Under the scheme of capital gains tax, a charge is created on any "transfer" of capital asset. The term 'transfer' is defined to, *inter alia*, include sale, exchange, relinquishment of a capital asset or extinguishment of any rights therein.
- ▶ Capital gains are computed by deducting from the full value of consideration, cost of acquisition of the capital asset and expenditure incurred in connection with transfer. Accordingly, if the resultant figure is positive, it is taxed; if it is negative, it results in a capital loss which is available for set-off in terms of the ITL provisions.
- ▶ The admissibility of capital loss arising in hands of shareholder on capital reduction has been a subject matter of judicial debate.
 - ▶ In *Karthikeya V Sarabhai vs. CIT* [1997] 228 ITR 163, the SC was dealing with a question whether reduction in face value of capital of preference shares would result in transfer of capital asset. In this case, the SC held that on reduction of face value of preference shares, the right of the preference shareholder to the dividend or the shareholder's share capital and the right to share in the distribution of the net assets upon liquidation is extinguished proportionately to the extent of reduction in the capital and, hence, the reduction in face value results in transfer of capital asset.
 - ▶ In *CIT vs. G Narasimhan* [1999] 236 ITR 327, the SC was dealing with a question whether reduction in face value of share capital results in transfer of capital asset. In this case, the SC after relying on earlier ruling in case of *Karthikeya V Sarabhai (supra)*, held that reduction of capital results in transfer of capital. The SC, further, clarified that in case of capital reduction, to the extent company possesses accumulated profits, amount received by shareholder will qualify as dividend income, and distribution over and above accumulated profits will only be exigible to capital gains taxation.
 - ▶ In *Bennett Coleman & Co. Ltd vs. ACIT* [2011] 133 ITD 1³, Mumbai Tribunal Special Bench disallowed a shareholder's claim for capital loss on reduction of share capital since the shareholder's percentage of shareholding, immediately before reduction of share capital and immediately after such reduction, remained the same. Also, in that case, there was no consideration received by the shareholder in lieu of reduction of share capital and hence, the Tribunal termed the shareholder's claim as merely a notional loss which cannot be allowed.
- ▶ In case of capital reduction involving payment of consideration to shareholders, Tribunal decisions in the cases of *Jupiter Capital Pvt Ltd.* (ITA No.445/Bang/2018, order dated 29 November 2018) and *Carestream Health Inc vs. DCIT* (ITA No. 826/Mum/2016, order dated 6 February 2020) have allowed capital loss suffered by holding company in event of capital reduction undertaken by the subsidiary company.
- ▶ In *Tata Sons Ltd. vs. CIT* (ITA No. 3468/Mum/2016), Mumbai Tribunal allowed capital loss arising on reduction of the share capital of a company by way of the cancellation of shares as it constitutes transfer under provisions of the ITL. It held that the capital gains tax provisions will apply even if no consideration is actually payable by the company. It held that such loss is not notional loss⁴.

Facts

- ▶ The Taxpayer, engaged in business of investing in shares⁵, leasing, financing, etc., had invested in equity shares of Asianet News Network Pvt. Ltd. (I Co) by holding 99.98% stake therein. Since the net-worth of I Co had eroded, I Co filed petition for capital reduction of its shares to set-off the loss against paid up equity share capital.
- ▶ The Bombay High Court (HC) approved the capital reduction scheme involving cancellation of shares of I Co from approximately 153.5 million shares to 0.01 million shares. As a consequence, the Taxpayer's holding in company was reduced from approximately 153.34 million shares to 9,998 shares. However, the face value remained same i.e. INR 10 per share. Basis HC order, I Co paid a consideration of approximately INR 31.78 million to the Taxpayer.
- ▶ The Taxpayer regarded the aforesaid capital reduction as a 'transfer' of a capital asset in terms of provisions of the ITL and claimed long term capital loss. In assessment proceedings, the Tax Authority disallowed Taxpayer's claim of capital loss

³ Refer EY Alert dated 4 October 2011 titled- "SB rules on whether the claim for capital loss pursuant to a capital reduction is allowable"

⁴ Refer EY Tax Digest March 2024 Edition. It may be noted that Tribunal observed that even in issue before *Bennett Coleman (supra)*, the Bench was divided, and the minority view in that decision corresponds to the view taken by the assessing tax authority in the instant case. The Tribunal held that the view taken by tax authority to allow capital loss arising on cancellation/reduction of share capital is a possible view and hence Principal Commissioner of Income Tax cannot hold the same to be erroneous for invoking its revisionary powers.

⁵ Though the facts of the case narrate that the Taxpayer was in business of investing, it seems that SC has proceeded on the basis that the Taxpayer held shares as capital asset and not stock in trade.

on the ground that the definition of 'transfer' under ITL covers "the extinguishment of any rights" which in the context of shares, refers to selling off or parting with the same to a second party. Whereas, in the Taxpayer's case, only number of shares had been extinguished but not the rights therein, as Taxpayer continued to hold same percentage of shares. The First Appellate Authority (FAA) upheld the order of the Tax Authority by stating that extinguishment of rights entails parting of percentage of shareholding. The FAA distinguished decision of *Kartikeya V. Sarabhai (supra)* on facts. The Bangalore Tribunal⁶ reversed the order of FAA by relying on SC decision in case of *Kartikeya V. Sarabhai vs. CIT (supra)*.

- ▶ On appeal to Karnataka HC⁷, the HC dismissed the appeal against Tribunal's order. It held that by reduction in the number of shares, the redeemable value of shares at the event of liquidation is reduced even if the overall shareholding percentage remains unchanged. It also followed the SC decision in the case of *Kartikeya v. Sarabhai (supra)* which held that reduction in number of equity shares would amount to a transfer as it constitutes extinguishment of rights in those shares.
- ▶ The Tax Authority filed SLP against the dismissal of appeal by HC against the order of Tribunal.

Held:

SC dismissed the SLP against order of HC and held that there is no error committed by HC. SC provided following reasons for dismissal of SLP.

- ▶ SC noted that transfer of shares on account of capital reduction is a settled issue. It noted decision of *Kartikeya V. Sarabhai (supra)* which laid down following ratio:
 - ▶ Definition of "transfer" under ITL is inclusive and *inter alia*, covers relinquishment of an asset or extinguishment of any rights in 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 shareholder's right as a shareholder qua the company.
 - ▶ The provision of corporate law enables companies to reduce the share capital and one of the modes which could be adopted is to reduce the face value of the preference share.
 - ▶ With reduction in face value, the share capital is reduced and the right of the preference

shareholder to the dividend or shareholder's share capital and the right to share in the distribution of the net assets upon liquidation is extinguished proportionately to the extent of reduction in the capital. Such a reduction of the right of the capital asset clearly amounts to a transfer under scope of ITL.

- ▶ It also noted Gujarat HC decision in case of *CIT vs. Vania Silk Mills [1977] 107 ITR 300⁸* which held that expression "extinguishment of any right therein" is of wide import and it covers every possible transaction which results in the destruction, annihilation, extinction, termination, cessation or cancellation, by satisfaction or otherwise, of all or any of the bundle of rights - qualitative or quantitative - which the taxpayer has in a capital asset, whether such asset is corporeal or incorporeal.
- ▶ SC held that while the face value remained same, there is extinguishment of rights of shares on account of reduction in number of shares. SC in *Kartikeya V. Sarabhai vs. CIT (supra)* has not made any reference to percentage of shareholding pre and post reduction of share capital.
- ▶ Further, SC referred to Gujarat HC in the case of *CIT v. Jaykrishna Harivallabhdas [1998] 231 ITR 108* wherein it was clarified that receipt of some consideration in lieu of transfer is not a condition precedent for the computation. Mere non receipt of consideration would not lead to failure of capital gain/loss computation. The receipt of consideration is not envisaged under provisions of ITL.
- ▶ SC also referred to its earlier ruling in case of *Anarkali Sarabhai v. CIT [1997] 224 ITR 422*, wherein SC dealt with capital gains arising on redemption of preference share capital by the company for consideration. SC held that when a preference share is redeemed by a company, effectively, the shareholder sells back the share to the company and such sale will fall within the phrase "sale, exchange or relinquishment" of an asset under ITL. Similarly, on reduction of preference share capital by a company, the right of the preference shareholder to the dividend or shareholder's share in the capital and the right to share in the distribution of the net assets upon liquidation is extinguished proportionately to the extent of reduction in the capital and such reduction clearly amounts to transfer under ITL. Thus, redemption of shares and reduction of shares both amount to transfer under provisions of ITL.
- ▶ Based on above, SC held that reduction in share capital of I Co and proportionate reduction in

⁶ ITA No. 445/Bang/2018, order dated 29 November 2018

⁷ PCIT vs. Jupiter Capital Pvt. Ltd. (ITA No. 299 of 2019) dated 20 February 2023

⁸ It may be noted that SC in case of *Vania Silk Mills Ltd v CIT [1991] 191 ITR 647* reversed the Gujarat HC ruling. SC in case

of *CIT v Grace Collis [2001] 248 ITR 323* held that on amalgamation of shares, shareholders of amalgamating company extinguish rights in shares of amalgamating companies and distinguished earlier SC ruling in case of *Vania Silk (supra)*.

shareholding of the taxpayer shall be construed as transfer under definition of ITL.

Comments

In case of transaction between holding-subsidiary (not being wholly owned), SLP dismissal lays down the principle that the transaction of reduction of share involves transfer even if overall shareholding remains unchanged.

The SC has dismissed the SLP by giving a reasoned order. While the doctrine of merger may not be applied, it becomes binding under Article 141 of Constitution of India ^[9].

In the facts of the case before SC, the transaction of capital reduction involved cancellation of shares for monetary consideration. Hence, in transactions where consideration is not specified, one may have to examine the applicability of said decision. However, SC referred and emphasized the Gujarat HC ruling in case of Jaykrishna Harivallabhdas (*supra*) which clarified that receipt of some consideration in lieu of the extinguishment of rights is not a condition precedent for the computation of capital gains.

Though, the present SC decision does not refer to its earlier ruling in case of G Narasimhan (*supra*), it has arrived at a similar conclusion.

⁹ Refer Khoday Distilleries Ltd v Sri Mahadeswara Sakhara Sakkare Karkhane Ltd [Civil Appeal No. 2432 of 2019] (SC), Kunhayammed v State of Kerala [2000] 6 SCC 359 (SC)

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