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TAX TRIBUNAL ALLOWS SHAREHOLDER'S CLAIM FOR 'CAPITAL LOSS' IN CAPITAL REDUCTION

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Introduction

The Bangalore bench of the Income Tax Appellate Tribunal (Tribunal) in a recent case of *M/s Jupiter Capital Pvt. Ltd. v The Assistant commissioner of Income Tax* (ITAT order dated 29 November 2018) has allowed the claim for capital loss on account of reduction in share capital of the company (Ruling). The Tribunal held that reduction of share capital results into extinguishment of rights which is provided for in the inclusive definition of "*transfer*" under section 2(47) of the Income-tax Act, 1961 (IT Act). The Tribunal relied on the judgment of the Honb'le Apex court in *Kartikeya Sarabhai v. CIT* (Kartikeya Sarabhai case) wherein it was held that reduction in the face value of the share amounts to extinguishment of rights and can also be considered as a transfer and any profit or gain which arises from the transfer of a capital asset is liable to be taxed under section 45 of the IT Act.

Background

M/s Jupiter Capital Pvt. Ltd. (taxpayer) held equity shares in its subsidiary company (Shares). The subsidiary went through a capital reduction process and the taxpayer was paid some consideration which was less than the cost of acquisition of the shares so reduced. Consequently, the taxpayer incurred a loss and claimed the same as 'capital loss' from the transfer of Shares.

The Income Tax Authority (Assessing Officer) alleged that since the shareholding pattern of the subsidiary company remained unaffected (as each shareholder's shares were reduced in the same proportion of their pre-capital reduction shareholding), the taxpayer did not relinquish its voting power or extinguish its rights in the Shares, and thus, no transfer (as envisaged under section 2(47) of the IT Act) had taken place. Basis this, the Assessing Officer disallowed the taxpayer's claim for capital loss.

Being aggrieved, the taxpayer filed an appeal with the first level appellate authority (CIT(A)) which confirmed the Assessing Officer's order and dismissed the taxpayer's appeal. Therefore, the assessee filed an appeal before the second level appellate authority (Tribunal).

Ruling

The Tribunal held that the reduction of share capital in the present case amounts to a 'transfer' as envisaged under section 2(47) of the IT Act since the taxpayer had extinguished its right in Shares and in lieu thereof had received some consideration

which was less than the cost of acquisition of the Shares. Therefore, capital loss on such reduction of shares should be allowed.

The Tribunal relied on *Kartikeya Sarabhai* case wherein the Apex Court noted that even though the assessee continues to remain a shareholder of the company even after the reduction of share capital, it is not possible to accept the contention that there has been no extinguishment of 'any part' of his right as a shareholder qua the company. The Tribunal also noted that there was no reference to the percentage of share-holding prior to reduction of share capital and after reduction of share capital in the above case.

Comments

The issue of characterization of gain or loss arising out of capital reduction has been a subject of constant debate between the taxpayers and the income tax authorities. While the general judicial trend has been that in a case where the capital reduction process has resulted in gains to the shareholders, the tax authorities have sought to tax the same as capital gains in the hands of the shareholders; whereas the claims for 'capital loss' have been challenged if no consideration was paid to the shareholder.

It is pertinent to note that a decision of the Special Bench of the Tribunal in *Bennett Coleman v ACIT* had 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. However, in the Bennett Coleman 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. Though the present case was different on facts (as in the present case, the taxpayer did receive some consideration), it is noteworthy that the Tribunal did not record any reasons to distinguish the present case from the Special Bench decision of the Tribunal in Bennett Coleman case.

Therefore, considering the above, whenever a capital reduction process results in a loss for the shareholder, whether such loss would be allowable or not would need to be carefully evaluated. Some factors which would be relevant in this evaluation would be – whether any consideration was paid to the shareholder in lieu of the capital reduction, whether the rights associated with the particular shares (which were available before capital reduction) remain intact post the capital reduction.

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