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Direct Tax Alert

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Capital loss following a capital reduction allowed to be carried forward

In a recent decision[1], the Mumbai Bench of the Income Tax Appellate Tribunal ('Tribunal') allowed a shareholder long-term capital loss following the cancellation of shares that were held in a wholly owned subsidiary.

Background

Carestream Health INC ('the taxpayer'), a foreign shareholder, held the entire share capital of Carestream Health India Private Limited, an Indian company (a 'wholly owned subsidiary' or 'WOS'). Pursuant to an order of the Bombay High Court, the WOS undertook a reduction of its share capital, by cancelling some of its shares and discharging the resulting consideration to its shareholder, i.e. the taxpayer. Of the total consideration that was discharged, the consideration to the extent of the accumulated profits of the WOS was treated as 'deemed dividend', and dividend distribution tax was accordingly paid thereon by the WOS. The remaining balance consideration was appropriated as the 'sale consideration' relating to the cancelled shares, and the long-term capital loss arising thereon was claimed by the taxpayer in its return of income for assessment year ('AY') 2011–12. This long-term capital loss that was claimed by the taxpayer was then the subject of litigation before the Assessing Officer ('AO'). The AO held that, as the taxpayer's shareholding in the WOS remained unchanged, no extinguishment of rights of the taxpayer occurred, and consequently no transfer occurred either. The key takeaways are explained hereunder.

1 Carestream Health INC vs. DCIT (ITA No.826/Mum/2016).

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The taxpayer's contention

- The taxpayer argued that, for the purpose of the 'transfer' relating to the capital asset, the asset that was under consideration was the 'shares', and not the 'percentage of the holding' in the WOS. Furthermore, following the capital reduction, the rights of the shareholder to any dividends and to a share in the net assets of the WOS in an event of its liquidation were also extinguished, resulting in a transfer as envisaged under section 2(47) of the Income-tax Act, 1961 (the 'Act').
- The capital reduction required the prior consent of the creditors, or the claims of the creditors had to be satisfied prior to such a reduction, which again signifies that there has been an extinguishment of the rights of the shareholders. The taxpayer also referred to various judgements[2] in order to support its contention that the cancellation of the shares resulted in the extinguishment of its rights, and that it therefore amounted to a transfer that was chargeable to tax as capital gains.

The revenue's contention

- The AO disallowed the taxpayer's claim of a long-term capital loss, since the shareholding of the taxpayer in the WOS before and after the capital reduction remained the same, indicating that there was no extinguishment of its rights following the cancellation. And, given that there was no extinguishment of rights, there was also no transfer, as per the Act.
- The AO relied upon the decision of the special bench of the Mumbai Tribunal in the case of Bennett Coleman & Co. Ltd,[3] in which it was held that no loss accrues to a shareholder in the event of a capital reduction. This is because there is no change in the intrinsic value of the shares, and there is similarly no change in the rights of the shareholders in relation to the shareholder's share in the company. Furthermore, the net worth of the company also remains unchanged. The AO contended that Bennett Coleman & Co. Ltd also relied upon the decision of the Supreme Court in the case of Rasiklal Maneklal HUF.[4]

The tribunal's ruling

- The Tribunal held that the sale consideration that was received by the taxpayer following the capital reduction was not taxed under any other head of income by the AO, thereby proving that the AO accepted that such consideration had been received following the capital reduction and taxed under the head of 'capital gains'. Furthermore, it was possible to compute the capital gains in the given case, since both the cost of acquisition and the sale consideration were readily available.

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2 Kartikeya vs. Sarabhai and Anr vs. CIT 228 ITR 163 (SC); CIT vs. G Narasimhan 236 ITR 327 (SC); CIT vs. Mrs. Grace Collis 248 ITR 323 (SC).

3 Bennett Coleman & Co. Ltd vs. ACIT [2011] 12 ITR (T) 97 (Mumbai).

4 CIT vs. Rasiklal Maneklal (HUF) 177 ITR198 (SC).

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- The Tribunal affirmed the taxpayer's argument that because the capital reduction only resulted in a loss on account of indexation, the AO had chosen to ignore such a loss. Had the taxpayer incurred a profit, then the AO would have charged the same to tax as 'capital gains'. The indexation benefit is provided by the statute, and therefore no malafide intention can be attributed to the taxpayer in claiming such a benefit.
- The Tribunal also distinguished the present case from that of Bennett Coleman & Co. Ltd (supra), due to the fact that, in the latter case, the share capital was reduced in order to set off the accumulated losses, and no consideration was paid to the shareholders on account of such a reduction. In the present case, however, the shareholder, i.e. the taxpayer, received consideration following the capital reduction.
- Furthermore, in the case of Bennett Coleman & Co. Ltd (supra), one kind of share was substituted for another kind of share, which the shareholder was entitled to receive, due to its holding of the original shares, and therefore the substitution would not tantamount to transfer. The Tribunal also referred to section 55(2)(v) of the Act, since the shareholder was to take the cost of acquisition of the original shares as the cost of the substituted shares, when computing the capital gains on the new shares. This section does not apply to the present case.
- The Tribunal also observed that the decision of Rasiklal Maneklal HUF (supra) was considered by the Supreme Court in the case of Grace Collis[5]. In this case, the Supreme Court held that the shareholder's rights to an asset –in this instance, the shares of the amalgamating company –were extinguished following the amalgamation and, therefore, a transfer of the shares of the amalgamating company had occurred, as per the provisions of the Act. Applying the same reasoning to the present case, a reduction of capital also results in a comparable 'extinguishment of rights', and the definition of 'transfer' covers a case ~~of~~ involving the 'extinguishment of rights' in relation to a capital asset.
- The Tribunal also relied upon several decisions to which the taxpayer referred, where, even though the shareholder continued to hold shares in a company following a capital reduction, the shareholder's rights were reduced as they related to the share capital of the company.
- The Tribunal held that the loss relating to the cancellation of the shares in the WOS pursuant to the capital reduction was to be allowed as a long-term capital loss, and that such a loss was eligible to be carried forward in subsequent years.

Dhruva's comments

Given the facts of the case, the Tribunal upheld the carrying forward of a capital loss due to a cancellation of shares following a capital reduction. Although various decisions of the courts have always held that a capital reduction amounts to a transfer on which capital gains arise, the decision of Bennett Coleman & Co Ltd (supra) caused some concern. However, the

5 CIT vs. Mrs. Grace Collis 248 ITR 323 (SC).

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Tribunal rightly distinguished the present case from the above decision, where no consideration was paid and the cancellation of the capital was only conducted in order to set off the accumulated losses of the company.

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