Gift of shares in a subsidiary by a company is not regarded as transfer under section 47(iii) of the Act and hence not liable to capital gains tax

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In brief

Recently, the Chennai bench of the Income-tax Appellate Tribunal (the Tribunal) in the case of **Redington India Limited** (the taxpayer) held that transfer of shares in a subsidiary, by way of a 'gift', was not taxable as capital gains under section 45 of the Income-tax Act, 1961 (the Act). Moreover, such a gift was eligible for exemption under section 47(iii) of the Act. It was further held that under section 48 of the Act, the computation mechanism failed where shares were transferred without consideration. Lastly, it held that the arm's length price (ALP) computation did not extend to international transactions where taxable income did not arise.

In detail

Facts

The taxpayer[1] had a wholly owned subsidiary (WoS) company, M/s Redington Gulf FZE (RGF Gulf). The taxpayer and RGF Gulf were engaged in the same line of business, with RGF Gulf mainly focussing its operations in Middle East and African Countries.

The taxpayer, in July 2008, initiated setting up of certain additional WoS' to expand its business. In connection with this, the taxpayer had set up a WoS in Mauritius, M/s Redington International Mauritius Limited (RIML). RIML in turn had set up a WoS in the Cayman Islands, M/s Redington International (Holdings) Limited (RIHL).

With the objective of raising funds for expansion of its business, the taxpayer entered into corporate restructuring. The taxpayer transferred its entire shareholding in RGF Gulf to RIHL without any consideration.

Accordingly, post this transfer of shareholding, RGF Gulf became a WoS of RIHL.

The tax officer (TO) held that the transfer of shares by the taxpayer could not be termed as a 'gift' for lack of natural love and affection, and therefore would not be covered by the exclusions covered under section 47(iii) of the Act. The TO further concluded that there was no business rationale in setting up overseas subsidiary companies, and that setting up the intermediary company in Mauritius was intended to frustrate the legislative intent enacted in section 47(iv) of the Act. Further, the TO held that such a transfer was an international transaction and was within the purview of transfer pricing regulations. Accordingly, the TO computed the ALP of the RGF Gulf shares and the capital gains tax thereon.

Pursuant to filing of objections by the taxpayer against the addition before the Dispute Resolution Panel (DRP), the DRP upheld the TO's order; however, the DRP granted certain relief in the manner in which the ALP for this transaction was computed.

[1] Redington (India) Limited *v.* JCIT [TS-419-ITAT-2014(CHNY)]

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Aggrieved by the order, the taxpayer appealed before the Tribunal.

Issues before the Tribunal

- Whether voluntary transfer of shares without consideration was a transaction of gift, and would be covered under the exclusion of section 47(iii) of the Act?
- Whether transfer pricing provisions would apply only to those international transactions which were liable to income tax in India?

Taxpayer's contentions

The counsel appearing on behalf of the taxpayer explained the following rationale for setting up the overseas subsidiaries:

- The taxpayer intended to raise funds for its overseas business operations;
- RGF Gulf had set up a Free Zone Enterprise (FZE) in Jabil Ali Free Zone Authority (JAFZA), Dubai. The FZE regulations do not permit more than one shareholder for enterprises operating under JAFZA. This was a roadblock in raising funds from Venture funds.
- The Private Equity Fund that was going to invest in the overseas operations of the taxpayer could invest only through investment vehicles. The Private Equity Fund had set up such an investment vehicle in the Cayman Islands; and
- Considering the geographic location of Mauritius, RIML was incorporated as an overseas holding company into which the non-Middle East and non-African investments could be consolidated.

Based on the above, the counsel argued that the incorporation of overseas subsidiaries was purely for commercial and business expediency and there was no motive to avoid tax. Further, all these transactions were approved by the regulators like the Reserve Bank of India, Stock Exchanges, Securities and Exchange Board of India, etc.

The counsel contended that the TO's conclusion that a corporate body could not make a gift to another, as 'natural love and affection' was a pre-condition to gift, was a gross error in law. The counsel referred to the definition of 'gift' under the Transfer of Property Act, 1882 (TPA) and erstwhile Gift Tax Act, 1958 (GTA)[2] and contended that a reading of the definition of gift declared beyond doubt that there was no need of any attribute like 'love and affection' for making a 'gift', and that a corporate body was eligible to make a gift like any other person. He also relied on various judicial precedents to support his contentions[3].

The counsel further contended that the 'gift' should be exempt under section 47(iii) of the Act. There was no restriction provided in the Act which prohibited a company from claiming exemption under section 47(iii) of the Act. Had the intention been to exempt only individuals, the legislature would have specifically stated so, as mentioned in other sections of the Act like sections 54, 55, of the Act, etc.. Since there was no ambiguity in the law, the literal meaning should be adopted in the context[4].

The counsel also contended that the computation mechanism of capital gains for charge of tax would fail because the transaction undertaken was without consideration[5]. The full value of the consideration for computation of capital gains tax should be the actual consideration received or accrued by the taxpayer. If there was no actual consideration, it was not permissible in law to substitute the fair value/ or estimated value of the property[6]. Such value substitution was absolutely against the law. Further, he explained that section 47(iv) of the Act did not control section 47(iii) of the Act, and each provision and each clause operated in its own field.

With respect to the transfer pricing provisions being applied by the TO, the counsel submitted that section 92 of the Act was a machinery provision. The section provided for determination of the ALP in certain cases. It would be applicable only if the transaction resulted in taxable income in the hands of the taxpayer. In cases where there was no transaction which resulted in taxable income, the transfer pricing provision could not be applied[7].

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[2] Section 2(xii) of the erstwhile Gift-tax Act 1958 / Section 122 of the Transfer of Property Act, 1882

[3] Deere and Company, *In re* [2011] 337 ITR 277 (AAR), DP World (P) Ltd *v.* DCIT [2013] 140 ITD 694 (Mum-Trib)

[4] Sarla Debi Birla *v.* CWT [1989] 176 ITR 98 (SC) / CIT *v.* Central Bank of India Ltd [1990] 185 ITR 6 (Bombay) / CIT *v.* National Agricultural Cooperative Marketing Federation of India Ltd [1999] 236 ITR 766 (SC) / Gracemac Corporation *v.* ADIT [2010] 134 TTJ 257 (Delhi-Trib)

[5] CIT *v.* B C Srinivasa Setty [1981] 128 ITR 294 (SC) / Dana Corporation, *In* re. [2009] 227 CTR 441(AAR)/ Amiantit International Holding Ltd, *In re.* [2010] 230 CTR 19 (AAR)/ Goodyear Tire and Rubber Co., *In re.* [2011] 334 ITR 69 (AAR)

[6] CIT *v.* George Henderson and Co Ltd [1967] 66 ITR 622 (SC)/ CIT *v.* Smt Nilofer I. Singh [2009] 309 ITR 233 (Delhi)/ CIT *v.* Gillanders Arbuthnot & Co. [1973] 87 ITR 407 (SC)

[7] Vanenburg Group B.V., *In re.* [2007] 289 ITR 464 (AAR)/ Dana Corporation, In re. [2009] 227 CTR 441(AAR)/ Amiantit International Holding Ltd, *In re.* [2010] 230 CTR 19 (AAR)/ Goodyear Tire and Rubber Co., *In re.* [2011] 334 ITR 69 (AAR)/ Deere and Company, *In re* [2011] 337 ITR 277 (AAR)

Revenue's contentions

The Revenue contended that by transferring the shares of RGF Gulf, the taxpayer not only avoided the payment of tax, but also arranged schemes to avoid tax perpetually. The Revenue authorities contended that it was a *sham* transaction arranged by the taxpayer company and justified the TO's reliance on the Supreme Court decision in the case of McDowell & Co. Limited[8].

The Revenue authorities further contended that the asset base of the group as a whole was steady, and in that case, there was no gift at all; therefore the question of exclusion under section 47(iii) of the Act did not arise. Further, section 48 of the Act would fail only if there was no means at all to compute the value of assets transferred. That part of the consideration must be a vacuum.

Tribunal's ruling

The Tribunal held that a gift was definitely a transfer of property. The term 'gift' was not defined in the Act, and hence the nearest enactments that could be relied upon for the purposes of deciding this issue were the TPA and erstwhile GTA. Section 5 of the TPA defined 'transfer of property' as an act by which a living person conveyed property, in present or in future, to one or more other living persons, or to himself, or to himself and one or more other living persons; and "to transfer property" was to perform such act. Further, 'living person' according to the same section 5 of the TPA included a company. The same expression, 'person' provided in section 5 was transplanted in section 122 of the TPA which defined 'gift'. The meaning given to the expression 'gift' in the erstwhile GTA was the same.

[8] McDowell & Co. Limited *v.* CTO [1985] 154 ITR 148 (SC)

The essential ingredients of a valid gift were the existence of a property, voluntary nature of the transfer, and absence of any consideration. As a pre-condition for making a valid gift, the law did not prescribe any attributes like "love and affection". The Tribunal relied on a Supreme Court case[9] which held that one should not try to confuse the purpose of making a gift with consideration. Accordingly, the Tribunal accepted the legal capacity of the assessee to gift its shares in RGF Gulf to RIHL. The Tribunal further held that where there was no specific rider in section 47(iii) of the Act in respect of a person eligible for claiming exemption under section 47(iii) of the Act, there was no need to read down the law to make an interpretation that a company could not claim exemption under section 47(iii) of the Act.

Based on the above, the Tribunal concluded that, given the facts and circumstances of the case, the transfer of shares made by the taxpayer company without consideration was a valid gift, and consequently, the transfer of shares could not be regarded as transfer of a capital asset for the purpose of capital gains taxation, as provided in section 47(iii) of the Act.

Relying on the Supreme Court decision of B. C. Srinivasa Setty[10], the Tribunal held that as the transfer of shares was made without consideration, the foremost ingredient of the computation provision was missing, and as such, capital gains tax could not be computed under section 48 of the Act. This led to a situation where section 45 of the Act could not be invoked and the charge of capital gains taxation failed.

[9] Ku. Sonia Bhatia vs. State of UP & Ors., 1981 SCR(3) 239

[10] CIT *v.* B. C. Srinivasa Setty [1981] 128 ITR 294 (SC)

Lastly, the Tribunal held that transfer pricing provisions would apply to only those international transactions which were liable to income tax in India. Accordingly, in the current case, so far as the issue of transfer of shares was concerned, transfer pricing provisions did not apply.

The takeaway

Gift of shares by corporates has been an often litigated issue. This ruling of the Tribunal has analysed the issue in detail and has ruled in favour of the taxpayer. However, one needs to be mindful of the relevant facts of each case before applying this ratio unilaterally. The commercial and business expediency for entering into a transaction would need to be evaluated in depth and on a case-to-case basis.

Further, post insertion of section 50D and section 56(2)(viia) of the Act, transactions would also need to be evaluated in light of these provisions.

Let's talk

For a deeper discussion of how this issue might affect your business, please contact:

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