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Long term capital loss on sale of shares of a group company partly to a related buyer and partly to an unconnected third party buyer allowed

In brief

Recently, in the case of J.M. Morgan Stanley Pvt. Ltd.[1] (the taxpayer), the Mumbai Tribunal (the Tribunal) upheld the long term capital loss (LTCL) claimed on sale of shares of a group company. The Tribunal rejected the Revenue's argument that the transactions of sale and purchase of shares were made with the ulterior motive of creating an artificial loss, as some of the shares had been sold to unconnected independent parties who held them for substantial period of time, and no benefit was derived by the taxpayer for that transaction.

[1] ITO *v.* J.M. Morgan Stanley Private Limited [TS-690-ITAT-2013(Mum)]

Facts

- The taxpayer, an investment banking company, filed its return of income for Assessment Year (AY) 2004-05 claiming an LTCL of INR 27.64 crore on sale of Optionally Convertible Preference Shares (the shares) of a group company.

- These shares were purchased on 27 March 1999 at a premium of INR 200 per share and were sold on May 14, 2003 at INR 3.30 per share.

- The shares were sold to one Mr. X, who was associated with the taxpayer company as Chairman.

- Mr. X sold 50% of the shares at INR 3.72 per share to a company wholly owned by Promoters (including his family) of the taxpayer company, who subsequently sold the shares to a third party.
- The balance 50% shares were sold to another unconnected third party, which ultimately sold them to a listed group company.
- The Tax Officer (TO) disallowed the taxpayer's loss claim, relying on the Supreme Court (SC) decision in McDowell & Company[2] and concluded that the entire transaction of purchase and sale of shares was a colourable device fabricated by the taxpayer for creating an artificial loss with the sole purpose of avoiding tax payment by setting off the amount against future income.
- The Commissioner of Income-tax-Appeals [CIT(A)] upheld the taxpayer's claim, considering that independent third parties had held the shares for a substantial period of time, and the taxpayer had received no benefit on account of these transactions.

Issue

Whether the transaction of sale of shares of a group company at a loss could be treated as a non-genuine transaction intended solely to create a loss to adjust against taxable income?

Revenue's contentions

- The transactions of purchase and sale of shares were a well conceived idea by the taxpayer to claim LTCL.
- It was a case of circular transactions between group companies to show an artificial loss, as 50% of the shares came back again to the same group.

[2] McDowell & Company *v.* Commercial Tax Officer [1985] 154 ITR 148 (SC)

- The Revenue also placed reliance on a Calcutta High Court (HC) decision[3] and a Kolkata Tribunal ruling[4].
- Further, the Revenue also submitted that there was no basis to support the valuation of shares at the time of purchase and it was only a negotiated price.

Taxpayer's contentions

- The taxpayer-company was a joint venture between JM Group and Morgan Stanley Group of the US, and the Morgan Stanley Group would not allow JM group to benefit from a transaction which was deterrent to their interests.
- The shares were sold at a value higher than that determined by a valuer, and the TO did not bring on record any other valuation report to show that the valuation or sale price was not correct.
- The shares were held by Mr. X for more than a year, and thereafter for another nine months by totally unknown parties. Further, even subsequently, 50% of the shares continued to be held by third parties.
- Mr. X's statement on oath that he and his family members had purchased the shares against payment had to be accepted, unless proved otherwise[5].
- Since Mr. X's subsequent sale of shares had been accepted as genuine and taxed by the Revenue, the present transaction could not be doubted[6].
- Loss was disallowed merely on the basis of presumption and surmises; and according to a SC decision,[7] no addition could be made on the basis of presumptions.

[3] CIT *v.* L.N. Dalmia [1994] 207 ITR 89 (Cal)
[4] Edward Keventer (P) Ltd *v.* DCIT [2004] 89 ITD 347 (Kol)
[5] Mehta Parikh & Co. *v.* CIT [1956] 30 ITR 181 (SC)
[6] Vishal P. Mehta *v.* DCIT [ITA No.3586/M/2009]
[7] K.P. Varghese *v.* ITO [1991] 131 ITR 597 (SC)

- Relying on two SC decisions, it was contended that the capital gains had to be computed on the “full value of consideration”[8].

- The taxpayer has not set-off capital loss arising from this transaction against long term capital gains till date, and this loss had since lapsed.

- Tax planning within the four corners of the law was permitted[9].

Tribunal ruling

- The Tribunal accepted the CIT(A)’s observations on the basis as follows:

  - There was no case of circular transactions, since the shares had been purchased by third parties and had been held by them for a substantial time before being sold at a profit.

  - 50% of the shares sold by the taxpayer were held by an outside corporate entity totally unconnected with the taxpayer, and the balance 50% were held by a listed group company, which never came back to the taxpayer.

  - The share valuation had been done by an independent Chartered Accountant, and the TO had not challenged it by carrying out his own valuation.

  - The principle laid down by the SC in the case of McDowell & Company[2] was not applicable in the taxpayer's case as there was no benefit derived either by the taxpayer or the group.

- The Tribunal distinguished the rulings of the Calcutta HC[3] and Kolkata Tribunal[4] on the basis that the facts in these cases were materially different. In the taxpayer’s case, shares were not only transferred to third parties totally unconnected with the taxpayer, but had also been held by those parties for a considerable time, and never came back to the taxpayer.

- Thus, the Tribunal upheld the CIT(A)’s order allowing the taxpayer’s claim of capital loss.

PwC observations

This judgment is reassuring for taxpayers undertaking genuine transactions with commercial considerations.

[8] CIT *v.* George Henderson and Co. Ltd. [1967] 66 ITR 622 (SC) and CIT *v.* Gillanders Arbuthnot & Co. [1973] 87 ITR 407 (SC)

[9] Union of India *v.* Azadi Bachao Andolan and Another [2003] 263 ITR 706 (SC) and Vodafone International Holdings B.V. *v.* UOI [2012] 341 ITR 1 (SC)

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