

## **‘Notional’ acquisition cost of rights not treated as cost of related party transaction that has no purpose except creating tax loss**

December 2, 2015

### **In brief**

In a recent decision, the Delhi High Court (HC), overruled the Delhi Tribunal’s decision to hold that loss on renunciation of rights between related parties could not be allowed when the transaction had no commercial purpose except to create a tax loss and to ensure that benefits of the asset remained within the group. Notional cost of acquisition of rights by treating difference between cum-rights and ex-rights prices of shares as cost of right could not be regarded as cost. It also held that since shares of the group company were sold within four months from the date of resolution, the gain on sale of shares and on renunciation of the other group company’s PCDs had to be taxed as ‘business income’.

### **In detail**

#### **Facts of the case**

- The taxpayer<sup>1</sup>, an Indian company, was an investment company.
- Over a period of time, it invested, *inter alia*, in shares of various group companies.
- Until April 1991, some shares were shown as stock-in-trade and some as investments, post which, pursuant to a Board resolution, all shares were classified as investments.
- During financial year 1991-92, the taxpayer sold group company shares and recorded long-term capital gain of INR 9.132 million.
- Later the same year, another group company

floated a rights issue of Partly Convertible Debentures (PCDs) wherein the taxpayer was entitled to subscribe to 5 PCDs for every 4 shares held.

- The taxpayer renounced the rights in favour of yet another group company at INR 30 per PCD.
- The cum-rights price of the group company’s shares was INR 625 per share, and ex-rights price was INR 425 per share.
- It was noted that forms for renunciation of rights were quoted on the stock exchange at prices between INR 260 and INR 280 per PCD. Thus, the taxpayer’s sale price was below the market price.

The taxpayer considered the difference between cum-rights price and ex-rights price, i.e. INR 200

(INR 625 - INR 425) per share as ‘notional’ cost of acquisition. The taxpayer claimed that it had incurred a loss of INR 16.9 million, being the difference between the sale price of rights and the ‘notional’ cost of acquisition of the rights.

- The Tax Officer’s (TO) disallowance of the loss was upheld by the Commissioner of Income-tax (Appeals) [CIT (A)]. The Tribunal overruled the CIT (A)’s decision and ruled in the taxpayer’s favour.

#### **Issues before the High Court**

- Whether the sale consideration received by the taxpayer by transfer of shares and sale of rights entitlement of PCDs was income from capital gains, and not income from business?

<sup>1</sup> TS-666-HC-2015 (Delhi)

- Whether the taxpayer had incurred loss on sale of the PCD rights entitlement and was thus entitled to set off the alleged loss from the capital gains/ income it earned?

#### **Taxpayer's key contentions**

- Pursuant to the Board resolution, the shares ought to be treated as capital asset, and not as stock-in-trade. The intention was always to hold the shares on a long-term basis.
- Transfer of shares from stock-in-trade to investments was not relevant for claiming loss on renunciation of rights.
- Relying upon the Bombay HC decision in KA Patch<sup>2</sup>, the taxpayer claimed that the method of calculation of loss on renunciation of rights would remain the same even if shares were held as stock-in-trade.

#### **Revenue's key contentions**

- The transaction was a sham transaction, and was entered into solely for the purpose of contriving a loss by relying unjustifiably on an SC decision in Dhun Dadabhoy Kapadia<sup>3</sup>.
- Since the taxpayer could not provide any reasons for selling rights at below the market price, and at the same time, the benefits of the asset remained within the group, the transaction was entered into for non-commercial purposes. It was not in aid of the taxpayer's business or its stated object of holding investments on a long-term basis.
- The taxpayer had funded a group company for investing in the PCDs.

- Resolution for conversion of stock-in-trade into capital asset was part of the device to avoid tax.

#### **High Court's Ruling**

- Insofar as the issue of treating the income as capital gains or income from business and profession was concerned:
  - The taxpayer himself had disclosed the shares as stock-in-trade, and was valuing it at lower of cost or market value.
  - In the assessment year 1988-89, the taxpayer had booked a loss on account of difference in purchase value and the value at which closing stock had been valued – thus, the taxpayer could not contend to the contrary.
  - The resolution was for retaining the shares as investments for long term but the taxpayer had entered into various purchase and sale transactions of shares of group entities. Thus, the taxpayer's actions were contrary to the purpose stated in the resolution.
  - Since the shares of the group company in question were sold within four months from the date of resolution, they could not be considered as long term capital assets.
  - Therefore, the gain on sale of the group company's shares and on renunciation of the other group company's PCDs was rightly taxed under the head, 'business income'.
  - Even otherwise, the taxpayer could not have claimed the gain on sale as

long term capital gain as the shares were not held as capital asset till the date of resolution i.e. 4 April 1991. On the sale of converted shares, the income up to the date of conversion need to be considered to be business income. However, as none of the counsel had taken up this argument, court did not conclude on this argument.

- On the loss on renunciation of rights to subscribe PCDs:
  - The first question was whether the transaction of renunciation of rights was a colourable device to contrive an artificial loss.
  - The HC answered this question in the affirmative, because (a) the rights were sold at a fraction of its actual market value, (b) sale of PCDs was far below the market price, (c) the rights were renounced to a group company, and (d) consideration for renunciation was not received in the same year.
  - In the real sense, the taxpayer had not incurred any loss, as the PCD renunciation price of INR 30 was more than the actual cost of the shares, which was less than INR 10 per share. At best, the loss claimed could be described as 'notional'.
  - A similar transaction was entered into by other group companies also.
  - Thus, the only purpose for executing transactions of renunciation of rights was to contrive a loss; there was no other purpose for entering into the transactions canvassed before the HC.

<sup>2</sup> CIT v. K.A. Patch [1971] 81 ITR 413 (Bombay)

<sup>3</sup> Dhun Dadabhoy Kapadia v. CIT [1967] 63 ITR 657 (SC)

- Referring to the SC decision in McDowell's case<sup>4</sup>, the HC held that tax planning was permissible, but a colourable device to avoid tax was impermissible.
- In view of above, the loss claimed by the taxpayer was a contrived loss. The HC did not find it necessary to decide the issue whether such loss could be set off against taxpayer's business income.
- So far as the cost of acquisition of the rights entitlement was concerned, it would be erroneous to impute notional cost after the taxpayer had drawn up its Profit and Loss Account applying mandatory

accounting standards and in accordance with the provisions of the Companies Act, 1956.

- A cost not actually incurred by the taxpayer could not be taken as the cost, which would amount to inflating the cost of acquisition.

### ***The takeaways***

The HC decision was based on the following grounds:

- The transaction was regarded as a sham transaction without any genuine business purpose.
- It did not seem that the taxpayer actually held the shares for long term purposes. This could be inferred by the taxpayer's actions of continuously dealing in shares of group companies.

- The method of computation of cost of acquisition was accepted by the SC in Dhun Dadabhoy Kapadia<sup>3</sup>, but in that case, the genuineness of the transaction was not questioned at all.

### ***Let's talk***

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

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<sup>4</sup> McDowell & Co. v. CIT [1985] 154 ITR 148 (SC)

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