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Redemption of preference shares amounts to 'transfer' and capital loss thereon is allowable

In brief

In a recent decision in the case of Parle Biscuits Pvt. Ltd.¹ (the “assessee”), the Mumbai Bench of the Income-tax Appellate Tribunal (the “Tribunal”) held that redemption of preference shares amounts to 'transfer' of a capital asset under the Income-tax Act (the “Act”) and any loss on redemption thereon would thus be allowable as a capital loss.

¹ Parle Biscuits Pvt. Ltd. v. ACIT [TS-477-ITAT-2011(Mum)]

Facts

The assessee claimed the capital loss on account of redemption of preference shares. The preference shares were allotted to the assessee company at face value of INR 1,000 per share and were redeemed in June 1997 at a value of INR 1,000 i.e. on the same value. The assessee claimed indexation benefit on the cost of acquisition. The resultant difference was claimed as a capital loss on redemption of preference shares. In doing so, the assessee relied on the Supreme Court decision in the case of Anarkali Sarabhai².

² Anarkali Sarabhai v. CIT [1996] 224 ITR 422 (SC).

The assessing officer (“AO”) did not agree with the above and stated that the receipt of money on redemption of preference shares has to be treated as dividend within the meaning of section 2(22)(d)³ of the the Act relying on the judgement of the Supreme Court in the case of G.Narasimham⁴. The assessing officer (“AO”) further held that since the amount was to be covered within the provisions of section 2(22)(d) of the Act, the question of claiming capital loss does not arise and since redemption took place after 30 June, 1997, the dividend was not taxable as such. He disallowed the capital loss pertaining to redemption of preference shares.

Issue before the Tribunal⁵

Whether the AO erred in disallowing the long-term capital loss arising on redemption of preference shares and including the amount received on redemption as deemed dividend?

Revenue’s contentions

Redemption of preference shares does not yield capital loss and the assessee had claimed only indexation loss as a capital loss. Since the amount received on redemption has been treated as deemed dividend, the question of allowing the loss does not arise.

³ Section 2(22)(d) provides that dividend includes any distribution made to the shareholders of a company on reduction of its capital, to the extent to which the company possesses accumulated profits which arose after the end of the previous year ending next before April 1, 1933, whether such profits have been capitalised or not.

⁴ CIT v. G.Narasimham & Others [1998] 236 ITR 327 (SC)

⁵ There were certain other grounds before the Tribunal, which has not been covered in this Alert.

Assessee’s contentions

The assessee contended that redemption of preference shares cannot result in a deemed dividend due to the following reasons:

- Redemption of preference share is covered by exception (i) to section 2(22)⁶ of the Act since preference shares are non-participating viz. the preference shareholder is not entitled to participate in the surplus assets in the event of liquidation
- Section 2(22)(d) of the Act refers to distribution to shareholders by a company on the reduction of its capital. Section 80(3) of the Indian Companies Act, 1956 provides that redemption of preference shares shall not be taken as reducing the amount of its share capital. Therefore, section 2(22)(d) of the Act does not apply to redemption of preference shares
- Reliance was placed on the decisions of the Supreme Court in the case of Anarkali Sarabhai (above) and Kartikeya Sarabhai⁷ which were rendered in the context of preference shares
- Even where the entire amount is treated as deemed dividend, the whole of the consideration received on redemption would be exempt from tax as dividend and since the assessee has redeemed the shares, the capital loss would go up by the same amount.

⁶ Exception (i) to Section 2(22) – Dividend does not include a distribution made in accordance with sub-clause...or sub-clause (d) in respect of any share issued for full cash consideration, where the holder of the share is not entitled in the event of liquidation to participate in the surplus assets.

⁷ Kartikeya Sarabhai v. CIT [1997] 228 ITR 163 (SC)

Observations and conclusion of the Tribunal

The Tribunal, relying on the Supreme Court decisions in the case of Anarkali Sarabhai (above) and Kartikeya Sarabhai (above), held that redemption of preference shares has to be considered as 'transfer' and loss on redemption thereof is an allowable long-term capital loss.

Further, the Tribunal observed that even if for the purpose of argument, the consideration is deemed as dividend, the same amount of consideration cannot be considered at the time of computing capital gains on redemption, and therefore, the assessee may be entitled to a higher loss on redemption.

On analysing the implications of section 2(22)(d) of the Act, the Tribunal held that since there is no reduction of capital in the given case, considering section 80(3) of the Companies Act, even though the amounts were distributed out of accumulated profits, the amounts received by the assessee cannot be construed as 'deemed dividend' and would therefore be considered as consideration received on 'transfer' in working out the capital gains.

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