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Sale of 'pledged' shares at a loss to a group company to offset gains is not a 'colourable transaction'

In brief

In a recent ruling in the case of Biraj Investment Pvt. Ltd.[1], the Gujarat High Court (the HC) held that sale of shares in loss-making companies by the company to another group company, during the same year in which it earned capital gains through the sale of some other investments, cannot be regarded as a colourable device carried out for avoidance of tax. The fact that the shares in loss-making companies were pledged with a financial institution would not prevent the transaction from qualifying as a transfer under section 2(47) of the Income-tax Act 1961 (the Act).

Facts

- Biraj Investment Pvt. Ltd. (assessee) sold certain shares in Rustom Spinners Ltd. during the financial year 1992-93, and earned long-term capital gains of INR 146,792 and short-term capital gains of INR 741,563.
- In the same financial year, the assessee sold shares in Rustom Mills and Industries Ltd. (RMIL) to Bijal Investment Pvt. Ltd. (purchaser company) resulting in a long-term capital loss of INR 838,798 which it used to offset capital gains.
- The assessee and the purchaser company were part of the same group and had common directors.

[1] ACIT *v.* Biraj Investment Pvt. Ltd. [2012] 24 Taxmann.com 273 (Guj)

- The assessee had pledged the shares issued by RMIL with IDBI Bank and had handed over executed transfer forms with IDBI Bank along with an undertaking that it would not transfer such shares.

- However, the assessee transferred shares in RMIL to a group company under an agreement dated 24 March 1993 and the purchaser company was given irrevocable power of attorney to deal with the shares in any manner it so wished. The assessee received the entire sale consideration.

Issues

- Whether the assessee could make a valid transfer of shares, which were pledged with a financial institution, resulting in a long-term capital loss for the assessee.

- Whether such a transaction can be said to be a device used to reduce the tax effect by applying the principles laid down in McDowell & Company[2]'s case.

Revenue's contentions

- Transfer of shares would be complete only when the share certificates, along with the duly executed share transfer forms, are delivered. Since the shares were pledged with a bank in this case, it could not have been validly transferred to the purchaser company.

- The transaction was carried out in order to create a capital loss for the assessee, so as to be able to utilise the loss to offset gains on another transaction.

- The genuineness of the sale transaction was questioned due to the fact that the sale of shares, delivery of which was not possible, was made to a group company which was aware of the bad financial condition of RMIL.

- Based on the Supreme Court (SC) ruling in McDowell & Co. Ltd. (above), the entire transaction was a colourable device adopted by the assessee to avoid payment of tax.

- The fact that the purchaser company agreed to purchase shares in RMIL at market value shows that the entire transaction was not genuine, given that such shares had no real market value.

- According to section 108 of Companies Act, 1956, certain requirements, such as the stamping and execution of the transfer deed, and its delivery to the company, are required to be fulfilled in order for the registration of shares to be valid. Such steps are mandatory, as was held in the case of Mannalal *v.* Kedar Nath[3], and they had not been undertaken in the assessee's case and therefore the transfer was not effective.

Assessee's contentions

- There is no provision in the Act or in any other law prohibiting the disposal of assets to a group company.

- Merely because the shares in RMIL were sold in the year in which the assessee made a profit on sale of some other shares, it cannot be stated that there was an attempt to avoid tax.

- Section 108 of the Companies Act, 1956, prohibits the "registration of transfer" of shares if the prescribed requirements are not fulfilled and not the "transfer" of shares, which has been upheld by the Madras High Court in the case of A.M.P Arunachalam *v.* A. R. Krishnamurthy[4].

- The assessee had executed an agreement for transfer, given irrevocable power of attorney to the purchaser company to deal in such shares as desired and the entire sale consideration on sale of shares in RMIL was received by the

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

[3] Mannalal Khetan Etc. *v.* Kedar Nath Khetan & Ors. Etc [1977] AIR 536 (SC)
[4] A.M.P Arunachalam *v.* A.R.Krishnamurthy [49 Company Cases 662 (Mad)]

assessee. This was sufficient to qualify the transaction as a transfer under section 2(47) of the Act.

- The ratio of the decision in the case of McDowell & Co. Ltd. (above) was diluted by virtue of a subsequent decision in the case of Azadi Bachao Andolan[5].

High Court ruling

The HC held that:

- The transfer of shares was complete for tax purposes, as the assessee had entered into a sale agreement, given a power of attorney and received full sale consideration.
- The sale of pledged shares, without the knowledge of the bank with which the shares were pledged, would result in an internal dispute between the parties which is outside the purview of this judgement. This would not affect the treatment of the transaction under the Act.
- There is no provision in the Act which prevents the assessee from selling loss-making shares to a group company. Further, there is no bar on the assessee to effect such a sale in the year in which it incurred gain.
- Under ordinary circumstances, the assessee is free to decide whether to hold on to certain shares or sell them to avoid further loss, if he finds that the market value is fast diminishing.
- It is not the case of the revenue that shares were sold at a price lower than the market rate and hence the question of inflating losses by transferring shares to a group company does not arise.
- Tax avoidance cannot include every case where reduction of tax liability is involved, as was held by the SC in the case of Sakarlal Balabhai[6]. It is permissible for the assessee to enter into a transaction which has the effect of diminishing his income in order to reduce his tax liability.

Conclusion

- Sale of shares would be possible, even if the share certificates evidencing the ownership of such shares were pledged with a bank. Though this may have other legal repercussions, the sale transaction would be complete from a tax perspective, on execution of a valid sale agreement and settlement of consideration.
- The transaction of sale of shares to a group company resulting in a capital loss, which was utilised to offset gains, cannot be regarded as a colourable device adopted to mitigate tax. This case would not be covered within the purview of the decision in the case of McDowell & Company Ltd. (above).
- This ruling is a departure from the decisions of the Madras High Court[7] and the Bombay High Court[8], in which capital loss was regarded as 'artificial' on a similar set of facts.
- Given divergent judicial pronouncements, a careful fact driven and informed position would have to be taken considering the facts and transactions in each case.

[5] Union of India *v.* Azadi Bachao Andolan [2003] 263 ITR 706 (SC)

[6] CIT *v.* Sakarlal Balabhai [1968] 69 ITR 186 (Guj)

[7] Premier Synthetic industries *v.* ITO [TS-444-HC-2012(Mad)]

[8] Killick Nixon Ltd. *v.* CIT [TS-148-HC-2012(Bom)]

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