

# Sharing insights

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## Gift of shares by shareholders to the company not a sham transaction and the subsequent sale results in capital gains

### In brief

The High Court of Karnataka (the HC), in its recent ruling<sup>1</sup> has upheld a gift of shares by the shareholders to the company as a genuine transaction, by treating the company as a separate legal entity, distinct from its shareholders. The HC, taking into account the main object of the company, held that the income arising from a subsequent sale of such shares is liable to tax as capital gains and not as business income.

### Facts

- Nadatur Holdings and Investments Pvt. Ltd. (the assessee) was incorporated under the Companies Act, 1956 on 16 February 2000 as an investment company.
- Two director shareholders of the assessee transferred 12,500 shares each, in Infosys Technologies Ltd., to the Company by way of a 'gift', i.e. without any consideration, by executing separate gift deeds on 23 February 2000.
- Of the above, the assessee sold 5,000 shares on 7 March 2000 and the balance was shown as investment in its books.

<sup>1</sup> CIT v. Nadatur Holdings and Investments Pvt. Ltd. [TS-656-HC-2012 (KAR)]

- Income arising on sale of such shares was treated as capital gains by the assessee and was accordingly offered to tax in its tax return.

### Issues before the HC

- Whether a gift of shares from shareholders to the assessee is genuine and permissible.
- Whether the income arising on sale of shares by the assessee would be liable to tax as capital gains and not as business income.

### Assessee's contentions

- There are no restrictions on the directors gifting the shares held by them to a company. Accordingly, the gift of shares by the directors to the assessee, supported by gift deeds, is genuine and in accordance with the law.
- According to the memorandum of association of the assessee, the main object of the company was to function as an investment company, i.e. to buy, invest, acquire and hold shares, stocks, debentures, bonds and not to trade in shares.
- Merely because an investment company realigns its investments does not mean that the income arising from such a transaction would be subject to tax as business income under the provisions of the Income-tax Act, 1961 (the Act), as held by the Supreme Court in its decision in the case of Dalhousie Investment Trust Company Ltd<sup>2</sup>.

### Revenue's contentions

- The principle element in a gift is the presence of natural love and affection for

the donee and the same is not present in the case of a gift to a company, which is an artificial juridical person.

- A gift of shares by the directors to the assessee-company, who were the shareholders of the company themselves, amounted to making a gift to oneself and is therefore not a genuine transaction.
- The dominant intention/real motive of the sale of the shares, which were received as a gift, was to do business and generate funds for the company.
- Sale of shares immediately after the gift resulted in substantial profit, which was liable to tax as business income and not as capital gains, as claimed by the assessee, since the assessee was involved in the business of trading in shares.
- A single transaction could constitute business income, as held by the Supreme Court in the case of Sutlej Cotton Mills Supply Agency Ltd.<sup>3</sup>, wherein it was observed that a single purchase/sale transaction could also constitute an adventure in the nature of trade and that it was not necessary to have a series of transactions to constitute a trading activity.

### HC Ruling

The HC held that:

- In common parlance, a gift is a transfer by one person to another of existing movable or immovable property made voluntarily and without consideration, and includes deemed transfer or conversion of any property.
- The transaction of a gift of shares to the assessee was valid and genuine as the assessee-company was a separate legal entity and there was no restriction on

<sup>2</sup> CIT v. Dalhousie Investment Trust Company Ltd. [1967] 66 ITR 473 (Kol)

<sup>3</sup> CIT v. Sutlej Cotton Mills Supply Agency Ltd. [1975] 100 ITR 706 (Nagpur)

gifting of shares by the shareholders to the company.

- The assessee is an investment company incorporated with the dominant intention to hold investment for capital appreciation and a mere sale of shares by the assessee cannot lead to a conclusion that it is engaged in trading of shares.
- Income from sale of investment by the assessee is an accretion to capital. In the absence of any evidence of trading activity, such income was liable to be taxed as capital gains, according to the principle laid down by the Supreme Court in *Sutlej Cotton Mills Supply Agency Ltd.* (above).
- Sale of investment purchased with an intention to earn capital appreciation is not convincing evidence to conclude that the transaction is in the nature of trade. For this purpose, reliance was placed on the Supreme Court decision in the case of *G. Venkataswamy Naidu and Co.*<sup>4</sup>, wherein the Supreme Court held that income from sale of capital investment amounts to realisation of capital and cannot be stamped as business/trading activity, merely due to its sale.

## Conclusion

- A gift of shares by the shareholders to the assessee is a genuine transaction, in the absence of a specific legal bar on such transactions.
- An isolated sale of shares by an investment company cannot lead to a conclusion that the company carries on trading or business activity and thus the income would be in the nature of capital gains only.

- On the question relating to the genuineness of the gift, we may note that this ruling is contrary to the recent ruling by the Authority for Advance Rulings in the case of *Orient Green Power Pte Ltd.*<sup>5</sup>, wherein it considered an inter-corporate gift as a 'strange' transaction and declined to give a final ruling. The assessing officer was asked to determine the validity and genuineness of the transaction. Hence, while making gift of shares to a company, one will need to consider these diverse rulings.

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<sup>4</sup> *G. Venkataswamy Naidu and Co. v. CIT* [1959] 35 ITR 594 (SC)

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<sup>5</sup> *Orient Green Power Pte Ltd. In re.*, [TS-608-AAR-2012]

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