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Purchasing shares at a very high price and selling them at a lower price to a group concern within a short span of time - not a genuine transaction, capital loss disallowed

In brief

In a recent decision in the case of Premier Synthetic Industries[1] (the assessee), the Madras High Court (HC) has disallowed the short-term capital loss arising on shares purchased at a higher price than the market and subsequently sold off to a group company at a lower price. It was held that the whole scheme of transaction was framed to effectively purchase its own shares by the company, which it could otherwise not have done legally.

Facts

- The assessee, a partnership firm purchased the shares of Premier Mills Ltd (PML) from Unit Trust of India (UTI) for INR 30 per share while the prevailing quoted market price was INR 8.50 per share only.

- The assessee subsequently sold the shares purchased at INR 30 per share within a short span of time to Belathur Investments Pvt Ltd (BIPL), a sister concern at INR 8.5 per share and claimed short-term capital loss in its return of income (ROI).

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

- The assessing officer (AO) disallowed the claim of assessee on the following grounds:
  - The managing director of PML had an agreement with UTI to purchase the shares of PML held by it at a pre-agreed price of INR 30 per share, which led to the assessee purchasing the shares at a price higher than the market price.
  - As per the correspondence between PML and UTI, it was PML which was under compulsion to buy back the shares of UTI.
  - There was no involvement of the assessee in price negotiation and there was absolutely no compulsion on the part of the assessee to acquire the shares at such fancy price.
  - The shares purchased by the assessee were fully paid by PML by adjusting the payments against outstanding dues to the assessee.
  - The assessee was used merely as a medium to transfer the shares at real market value to the nominee of PML so that PML remains under the effective control of its own people.
  - During the period, PML paid a turnover incentive to the assessee (which was withdrawn after the share transaction was completed), so that the assessee can make good the loss resulting from the shares transaction.
- The Commissioner of Income Tax (Appeals) (CIT (A)) upheld the order of the AO.
- The Income-tax Appellate Tribunal (Tribunal) affirmed CIT(A)'s view and held that:
  - PML utilised the services of the assessee firm only to escape the provisions of section 77 of the Companies Act, 1956 (Companies Act), which restricts a company from purchasing its own shares.
  - As there was no agreement between the assessee and UTI, it cannot be said that the assessee had to purchase the shares at a higher price as per any agreement.
  - Thus, when the market price was INR 8.5 per share, it was not prudent to buy shares at a higher price of INR 30 per share except to keep the control over PML by its own people.
  - There was no evidence to show that the trail of flow of funds by the assessee for the purchase of shares and that the transactions were genuine transactions.

Issue

Whether the above mentioned transaction of share purchase and share sale was a genuine one and whether the resulting loss arising from sale of shares should be allowed as short-term capital loss?

High Court ruling

The HC held against the assessee on the following grounds:

- As PML could not purchase its own shares in view of section 77 of the Companies Act, it merely used the assessee company as a special vehicle to repurchase its own shares which subsequently sold the same to a sister concern.
- There was no correspondence/agreement between the assessee and UTI with regard to the purchase price of INR 30 per share, particularly, when the quoted market price was INR 8.5 per share.
- There are no special reasons assigned for buying the shares at such a higher price when they were to be sold within a short span of time at the market price of INR 8.5 per share.
- There is hardly any materiel to show that the funds for the purchase of these shares really went from the assessee company.

Conclusion

On account of the above reasons, the HC held that the transaction of sale and purchase of shares was not a genuine transaction and consequently, the loss arising from the share transaction would not be allowed to the assessee.

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