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News Alert
17 June 2013

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Sale of a company's shares cannot be treated as sale of immovable property held by that company merely because the transaction escaped taxation

In brief

The Karnataka High Court (HC) has recently delivered a judgment in the case of Bhoruka Engineering India Ltd.[1] dealing with the issue of tax planning. After considering in detail three decisions of the Supreme Court (SC) and one of its previous decisions, the HC held that if a transaction is real and legitimate, and conditions for exemption have been clearly fulfilled, the Revenue cannot treat a transaction of sale of shares as a transaction of sale of immovable property held by the company whose shares were sold, merely because the Revenue would not collect any tax. The taxpayer had exploited a loophole, which was open to Parliament to plug by amending the law.

Facts

- Bhoruka Steel Ltd. (BSL), a group company of the taxpayer, was a sick company that owned, *inter alia,* 30 acres of land that it proposed to sell under the supervision of an asset sale committee (ASC). BSL owed money to several banks, and under a scheme of reconstruction under the Sick Industrial Companies (Special Provisions) Act, 30 acres was offered for sale at not less than a value per acre fixed by a registered valuer.

[1] Bhoruka Engineering Inds. Ltd. *v.* DCIT [TS-252-HC-2013(KAR)]

- According to the terms agreed between the promoters and the ASC, if no offer was received for at least the value fixed by the valuer, the promoters would be obliged to buy the land at the valuer's valuation.

- Only one offer was received for less than the minimum value agreed upon. Subsequently, Bhoruka Financial Services Ltd. (BFSL) a group company, offered to purchase the entire land. However, after a meeting the ASC decided to sell half the land (15 acres) to BFSL, in which the taxpayer too was a shareholder, for INR3.75 crores (the valuer's figure).

- The promoter-family and its group companies, including the taxpayer, owned over 98% of shares in BFSL which it had held for over 10 years. The shares of BFSL were listed on the Bangalore and Magadh Stock Exchanges, but were hardly traded.

- After purchase of the land, BFSL sold all its assets except the land within a few months, and then the promoters of BFSL (including the taxpayer) sold their entire shareholding to a developer for INR 89 crores. They claimed exemption under section 10(38) of the Income-tax Act, 1961 (the Act) in respect of the capital gains arising on sale of shares.

- The sale was done through a transaction on the Magadh Stock Exchange, and securities transaction tax was paid on the full value of the transaction. The taxpayer had applied to the SEBI for exempting them from making a public announcement/open offer for the sale of shares.

Contentions of the Revenue

- The tax officer (TO) contended that the act of selling the shares of what was reduced to a "shell company" that owned almost nothing else save the purchased land, amounted to a sale of the immovable property. Since this sale was within less than 36 months of the acquisition of the property, the entire gain was taxable as short-term capital gain.

- The TO justified this view by relying on the decision in McDowell & Co.[2] wherein it was held, *inter alia*, that the Revenue authorities were entitled to ignore the form and look at the substance of the transaction if they found that a colourable device had been used and that the transaction was a sham. The act of systematically divesting all assets other than the land, and thereafter selling the shares of the company owning the land was, they contended, a colourable device and a sham intended only to escape paying tax. This was obvious from the fact that the land acquired for INR 3.75 crores was effectively sold for INR 89 crores (of which the taxpayer's share was INR 20.3 crores) within a few months, with no tax liability whatsoever. The substance of the transactions was that the land was bought and sold within a few months of its acquisition, and therefore yielded a short-term capital gain taxable as such.

- Both, the Commissioner of Income-tax (Appeals) and the Income-tax Appellate Tribunal (the Tribunal), upheld the TO's view. The taxpayer therefore appealed to the HC.

Contentions of the taxpayer

- The taxpayer contended that it had a choice of two routes. Either the company could sell its property by a registered sale deed, or the shareholders of the company could sell their holdings. The mere fact that the route chosen resulted in escaping liability to tax did not make the transaction a colourable device or a sham. They had fulfilled all conditions to be eligible for exemption under section 10(38) of the Act, which was unambiguous in its language.

- The taxpayer relied on the Supreme Court's decision in Azadi Bachao Andolan[3] to contend that it had a right to choose the route that resulted in the lowest tax

[2] McDowell and Co. Ltd. *v.* CTO [1985] 154 ITR 148 (SC)
[3] UOI *v.* Azadi Bachao Andolan and Anr. [2004 AIR 1107 (SC)]

effect. The same principle had also been upheld in the Videocon case[4] and in the case of Vodafone Holdings BV[5].

Issues before the High Court

1. Whether the Tribunal's finding that the transfer of shares by the taxpayer would amount to sale of immovable property held by the company whose shares were sold, and the capital gains arising on such sale of shares would be liable to be assessed as capital gains arising on sale of immovable property, is perverse and arbitrary?

2. Whether the finding of the Tribunal that the taxpayer was not entitled to the benefit of exemption under section 10(38) of the Act was contrary to law?

High Court's Ruling

- The shares were traded through the Magadh Stock Exchange, and securities transaction tax had been paid in respect of the transaction. The sale had happened after Chapter 7 of the Finance Act 2 of 2000 had come into force. Thus, all conditions of section 10(38) of the Act had been fulfilled. The section did not make any distinction between companies owning immovable property and companies owning movable property.

- The taxpayer had held the shares in BFSL since 1984, and hence it was a long term capital asset. Merely because the land could have been sold in a different manner that would have attracted tax is no reason to deny the tax exemption. The taxpayer had merely taken advantage of loopholes in the law, which it is open to Parliament to plug. The transaction was real, valuable consideration had been paid and what was transferred were the shares, and not the immovable property.

- The TO's finding that the sale of shares was in effect a sale of immovable property was contrary to law, and to the material on record. Proceeding on this assumption was a serious error. The orders of all three lower authorities were set aside, and the questions of law before the Court were answered in favour of the taxpayer.

- The HC noted that thrice before in McDowell (at para 45), Azadi Bachao Andolan (at para 146), and in Vodafone Holdings BV (at para 64), the SC has laid down that tax planning may be legitimate provided it is within the framework of the law and without use of colourable devices or subterfuges. In addition, the same HC and the Andhra Pradesh HC too had held similarly.

PwC Observations

This judgment has once again shone a light on the debate of tax planning and avoidance *versus* tax evasion. It has reiterated the principle, laid down by the SC in the McDowell, Azadi Bachao Andolan, and Vodafone Holdings BV cases, as also the recent Sanofi Pasteur Holdings' judgment[6] of the Andhra Pradesh HC, that *"tax planning may be legitimate provided it was within the framework of law. Colourable devices cannot be a part of tax planning and it was wrong to encourage or entertain the belief that it was honourable to avoid the payment of tax by resorting to dubious methods"* – a principle first laid down in the majority judgment in the McDowell case. The HC noted that J. Reddy's comments in his separate judgment in the McDowell's case, about the need to depart from the Westminster principle, has been read down in all the other three apex court judgments cited above, and quoted the Vodafone judgment (para 64) to say that the majority decision in the McDowell case agreed with J. Reddy's observations *"only in relation to tax evasion through use of colourable devices by resorting to dubious methods and subterfuges"*. Thus, there is no obvious conflict even in the McDowell judgment itself.

[4] State of Karnataka *v.* M/s. Videocon International Ltd. [STRP No. 4/2000] (Kar.)
[5] Vodafone International Holdings BV *v.* UOI [2012] 341 ITR 1 (SC)
[6] Sanofi Pasteur Holdings SA *v.* Department of Revenue [TS-57-HC-2013(AP)]

The HC also refers to the Vodafone case in which it rejects reconsideration of the McDowell case by a larger Bench by holding that *"Revenue cannot tax a subject without a statute to support and in the course we also acknowledge that every tax payer is entitled to arrange his affairs so that his taxes shall be as low as possible and that he is not bound to choose that pattern which will replenish the treasury."*

There are thus no contradictory decisions of the SC, or instances where one Bench of the SC has disagreed with the view of another Bench. Usually, only complicated questions of law on which there is uncertainty are referred to larger Benches. It would be interesting to note what the SC decides on the Special Leave Petition filed by the Revenue before it recently in the Sanofi case, seeking reconsideration of the SC's decisions in Vodafone, Azadi Bachao Andolan and McDowell cases by reference to a larger Bench.

Incidentally, the Expert Committee Report on GAAR, dated 14 Jan 2003, in Example 13 thereof and in Example 26, have discussed circumstances similar to the above case, though in the context of granting or denying treaty benefits. In Example 13, with reference to option 1 which describes similar facts as in this case, the Expert Committee has opined that:

'*The taxpayer exercises the most tax efficient manner in disposal of its assets through proper sequencing of transactions.*

The Revenue cannot invoke GAAR as regards this arrangement.'

It seems that even under GAAR, which is yet to be implemented, the above case would escape taxation. Slight difficulty is created by Example 26 of the same report, where a very short period of holding of the asset preceded by non-arm's length pricing of the purchase is viewed with suspicion because it does not show commercial substance.

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