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Losses with respect to sale of shares and diminution in the value of stock of shares are not allowed since they are held as sham transactions

Background

Recently, the Delhi High Court (High Court) in the case of Vishishth Chay Vyapar Ltd.[1] (the taxpayer) disallowed losses on account of transactions of sale and purchase of shares and diminution in the value of stock since such transactions were a sham. There were only book entries and no payment was made for the purchase of shares during the year. Even though the companies in question may have been listed on the stock exchange, their shares were not actively traded and the transactions were amongst inter-related parties.

Facts of the case

- During the years[2] under consideration, the taxpayer filed its return of income declaring an income of INR0.1 million. The said income was calculated after claiming a loss on account of purchase and sale of shares and diminution in the value of shares held by the taxpayer.
- The Assessing Officer (AO) disallowed the loss claimed by the taxpayer. The AO held that the taxpayer had purchased most of the shares from a broker of the Gauhati stock exchange. Although the value of these transactions was large, no payments for the same were made and the consideration for purchase of said shares was reflected as outstanding and payable to a broker. The broker neither charged any interest nor instituted any proceedings for recovery of the said amount. The AO held that the said broker was not a person of means and the transactions were bogus.
- The Commissioner of Income-tax (Appeals) [CIT(A)] accepted the contract notes and other documents produced by the taxpayer as evidence of the genuineness of the transactions of sale and purchase of shares as well as reduction in their value and allowed the loss claimed by the taxpayer.
- The Income-tax Appellate Tribunal (the Tribunal) upheld the order of the CIT(A).

High Court's ruling

- The facts of the present case indicate that the shares of companies in respect of which losses were booked were floated by one promoter by introducing his undisclosed income. In addition, the said companies also held substantial shares in the taxpayer.

[1] CIT v. Vishishth Chay Vyapar Ltd (ITA 1105/2010) – Taxsutra.com

[2] Assessment Years 1996-97, 1997-1998, 1998-1999 and 1999-2000

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- There was a link between the companies floated by the promoter and the taxpayer. The AO found that the shares of those companies were not actively traded and there was no material on record, which would indicate otherwise.

- The certificate from Gauhati stock exchange does not indicate the volume of shares traded but only indicates quotation of shares on certain dates. There was no trading on other dates and there was hardly any trading on the shares of such companies.

- Since the shares in question are not actively traded, their quotations at the stock exchange could easily be manipulated by showing transactions in small number of shares. The stock certificates of Gauhati stock exchange for Assessment Years (AYs) 1998-99 and 1999-00 also indicate that the traded prices are related to 'off the floor' transactions which were reported to the exchange. Thus, the transactions entered into by the taxpayer and/or the related entities were itself the basis of the quotations. Therefore, it could not be relied on the said quotations for justifying the value of the shares in question.

- The shares, which are alleged to have been purchased by the taxpayer, were not paid for and only book entries were passed. Through a series of transactions which were, essentially, book entries, the taxpayer had devised a loss to set off against its other income. The AO's reasoning that the transactions were not genuine was based on cogent material and after examining the entire facts of the case.

- The CIT(A) failed to consider any of the reasons provided by the AO for holding the transactions to be not genuine.

- The transactions entered by purchase and sale of shares were sham transactions and could not be relied upon. The decisions[3] referred by the CIT(A) were not applicable to the facts of the present case. The CIT(A) failed to apply its mind to the aforesaid aspects and therefore, the orders passed by the CIT(A) were unsustainable.

- Undoubtedly, contract notes, confirmation memos, bills, books of accounts are evidence of genuine transactions. However, where the fundamental transaction is shown to be a sham transaction, the same cannot necessarily be accepted as genuine.

- The Tribunal fell into error in upholding the orders of CIT(A). There was no evidence to indicate that all shares were bought through the stock exchange.

- In the present case, bulk of the shares were claimed to have been sold/purchased by a broker. The memos of confirmations by a broker in respect of shares purportedly purchased by the taxpayer indicate that a broker had sold the shares to the taxpayer. These memos of confirmations were not contract notes evidencing purchase or sale of shares by a broker through the stock exchange for and on behalf of the taxpayer.

- In case, a broker had purchased the shares through the stock exchange for the taxpayer, in the normal course, he would have issued a contract note indicating the shares bought for the taxpayer.

- The AO had also found that the shares of companies were listed on spot basis. However, in the present case, the taxpayer had not made payment for the said shares and this was contrary to the prevalent practice. Thus, the finding of the Tribunal, to the effect that all shares were transacted through the stock exchange, is not supported by any material and is perverse.

- None of the material produced by the taxpayer could be relied upon to indicate the market value of the shares. The dates and quotations certified, clearly pertained to the transactions involving the taxpayer and or related companies as parties.

- The dates of the memos of confirmation and the date of transaction reported to the stock exchange are the same in almost all instances. Thus, these certificates, which only certify the prices at which transactions in question were reported, cannot prove that the transactions were executed at market value.

- The transactions in the present case were not done in the open market, but between related concerns. No other transactions in those shares were reported and any price at which the taxpayer transacted would be reflected as a quotation by the Gauhati stock exchange.

- The Tribunal rejected the AO's finding that the broker was not a person of means by holding that the issue of a broker's creditworthiness was covered by the Tribunal's earlier order. However, the Tribunal did not return any finding on the question of the broker's creditworthiness. Therefore, the Tribunal grossly erred in holding that this issue was covered by the Tribunal's earlier decision.

[3] CIT v. Dhawan Investment and Trading Co. Ltd. [1999] 238 ITR 486 (Cal), CIT v. Currency Investment Co. Ltd. [2000] 244 ITR 494 (Cal), CIT v. Carbo Industrial Holdings Ltd. [2000] 244 ITR 422 (Cal), CIT v. Kundan Investment Ltd. [2003] 263 ITR 626 (Cal), CIT v. Janki Textiles & Industries Ltd. [2003] 132 Taxman 231 (Gau)

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- The promoter was the prime mover of the companies in question. The taxpayer had booked losses in respect of shares of certain companies. The close link between the said companies and the taxpayer was clearly established. The link established between the taxpayer and these companies was important in considering the question whether the transactions of shares were genuine or not.

- The fact that the share application money was introduced in different names by a promoter, indicates that although there may have been a number of shareholders, the *de facto* control of the companies as well as its shares vested with only one promoter. The Tribunal grossly erred in completely ignoring the aspect of inter-linked entities and overlooking the perspective outlined by the AO.

- The Tribunal erred in ignoring certain relevant facts. Further, its finding that transactions for purchase and sale of shares are genuine, is perverse.

- Accordingly, losses claimed by the taxpayer were disallowed.

Our comments

The Delhi High Court in the present case has held that claim of loss on account of sale and purchase of shares and diminution in the value of stock of share cannot be allowed since the transactions were done by book entries and no payment was made for the purchase of shares during the year. Even though the companies in question may have been listed on the stock exchange, their shares were not actively traded and the transactions were amongst inter related parties.

As per the General Anti Avoidance Rule (GAAR) provisions, which are proposed to be introduced with effect from financial year 2017-18, the AO may treat the transaction as 'impermissible avoidance arrangement' if the main purpose of the transaction is to obtain tax benefit. Accordingly, the AO may disregard/combine/re-characterise whole/part of the arrangement.

The final report on GAAR issued by the Shome Committee provides illustrative cases where in Example 9 it is stated that sale/purchase through stock market transactions would not be covered under the GAAR provisions.

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