Loss claimed on account of the transaction of renunciation of rights is a colourable device

Background

Recently, the Delhi High Court in the case of Abhinandan Investment Ltd.[1](the taxpayer) held that the income received from the sale of shares and the renunciation of rights is business income and not capital gains since the taxpayer had reflected the shares as stock-in-trade. The closing stock was valued at cost or market value, whichever is lower. Therefore, this treatment could only be accorded to shares held as stock-in-trade and not as an investment.

The High Court observed that in order to avoid paying tax, the taxpayer had entered into transactions for renunciation of rights with related companies of the same group. These incestuous transactions were for no other business purpose but to contrive a loss in the hands of the companies. The transaction of sale of rights is considered as a transaction to purchase taxable losses for the purpose of evading tax. The loss claimed by the taxpayer was a contrived loss and the transaction of renunciation of rights was a colourable device to claim such a loss.

Facts of the case

- The taxpayer is one of the companies belonging to the Jindal Group, which is mainly engaged in manufacturing and production of ferrous metal and alloys. Jindal Iron & Steel Co. Ltd (JISCO) and Jindal Strips Limited (JSL) and Saw Pipes Ltd. are among the principal manufacturing companies of the Jindal Group.
- In addition to the manufacturing concerns, the Jindal Group also includes investment companies which, *inter alia*, hold shares of the other manufacturing companies.
- The taxpayer was incorporated on 6 April 1983 and its directors were Sajjan Kumar Jindal and Anand Prakash Garg. At the initial stage, 1,20,000 equity shares of INR10 each were offered to the public for subscription. Subsequently, the taxpayer declared that 50 per cent of the public issue was its income. This declaration was made under an amnesty scheme available at the material time.
- During the Assessment Year (AY) 1984-85, the taxpayer made investments in shares of the following companies:
  - JSL (79,800 shares)
  - Nalwa Steels Ltd. (50,000 shares) and
  - JISCO (3,50,000 shares).

  Thereafter, the taxpayer had further purchased shares of JISCO and the same were reflected in the closing stock.
- On 4 April 1991, the directors of the taxpayer passed a resolution that the shares and debentures held in various companies which were shown as stock-in-trade, were to be reflected as an investment as the said securities were intended to be retained on a long-term basis.
- During the relevant financial year, the taxpayer sold an aggregate of 60,000 equity shares of JSL for a consideration of INR17.26 million. The taxpayer declared that the said transaction has resulted in income by way of long-term capital gains amounting to INR9.13 million.

[1] CIT v. Abhinandan Investment Ltd (ITA No. 130/2001) – Taxsutra.com

- During the relevant period, JISCO floated a rights issue of Partly Convertible Debentures (PCDs). In terms of the said issue, the taxpayer was entitled to subscribe to five PCDs for every four shares held by the taxpayer. The taxpayer renounced its entitlement for subscribing to 1,29,688 PCDs in favour of JSL on 15 February 1992 i.e. one day after the rights issue opened for subscription.

- The shares of JISCO were quoted at a cum rights price of INR625 on 3 January 1992 and were quoted at INR425 per share ex rights on 6 January 1992. On the basis of the aforesaid drop in prices, the taxpayer claimed that the cost of acquisition of the rights was INR200 per PCD. The rights to subscribe to PCDs were sold by the taxpayer to JSL at a consideration of INR30 per PCD at an aggregate consideration of INR3.89 million.

- Thus, the taxpayer claimed that it had incurred a loss of INR16.86 million. This was computed by calculating the diminution in value of 1,03,750 shares of JISCO, on the basis of which the taxpayer acquired the right to subscribe to 1,29,688 PCDs.

- The Assessing Officer (AO) observed that the consideration for renunciation of rights had not been received in the financial year. The renunciation of right forms was quoted on the stock exchange at a price ranging from INR260 to INR280 per PCD and, thus, sale was made below the market price. The AO noted that the taxpayer could not provide any reason for selling the rights to subscribe to PCDs at below the market price.

- The AO held that the transfer of shares held by the taxpayer from the stock-in-trade to investments, renunciation of rights at below the market price, and the renunciation of rights to subscribe PCDs were sham transactions to purchase losses. The Commissioner of Income-tax (Appeals) [CIT(A)] upheld the order of the AO. The CIT(A) further held that the principle laid down by the Supreme Court in the case of McDowell & Co.[2] was fully applicable to the facts of the present case.

- The Income-tax Appellate Tribunal (the Tribunal) held that the loss claimed by the taxpayer on the renunciation of rights to subscribe to PCDs of JISCO was allowed to be set off against the profits made by the taxpayer. The Tribunal held that the shares of JSL or JISCO held by the taxpayer were investments and not trading assets. Consequently, it was entitled to compute the cost of acquisition of rights to subscribe to PCDs. The Tribunal concluded that the sale of shares of JSL by the taxpayer was to preserve its assets and the sale of shares of JSL indicated that the taxpayer was interested to buy the PCDs of JISCO.

High Court ruling

Classification of income received by the taxpayer from the sale of shares

- The Tribunal proceeded on the basis that it was always the intention of the taxpayer to hold the shares as investments and not to trade in them. However, this is unsustainable because the taxpayer had itself reflected the shares as stock-in-trade. The taxpayer had also valued the closing stock at cost or market value, whichever was lower. Therefore, this treatment could only be accorded to shares held as stock-in-trade and not as an investment.

- It was not the taxpayer's case that the said shares be treated as investment from the date when they were purchased but were to be retained as investments after the date of the purported resolution, which would have otherwise clearly stated so and the shares would be transferred at cost and not at the cost or market value whichever was lower.

- Although the resolution dated 4 April 1991 specifically stated that the shares and debentures transferred to investments in the balance sheet as on 31 March 1992, 60,000 shares of JSL were sold in August 1991, that is, within a few months after passing of the purported resolution and much prior to the end of the financial year. Thus, the said 60,000 shares of JSL, which were reflected as stock-in-trade, were never reflected as investments in the balance sheet as on 31 March 1992.

- Secondly, none of the statutory filings with the Registrar of Companies (ROC) reflected the shares in question as stock-in-trade prior to the transactions of the sale of shares, as the same were sold prior to the end of the financial year. Thirdly, the taxpayer was not a widely-held company. Although, its shares were offered to the public, 50 per cent of the capital raised had been surrendered as undisclosed income of the taxpayer. This clearly indicates that the shareholding was fictitious and undisclosed income of the promoters.

- It is also relevant to note that the taxpayer further acquired 40,000 shares of JISCO in July 1992, that is, within a few months of selling its rights to subscribe to the PCDs. These shares were purchased at the rate of INR300 per share. Thereafter, within the same financial year, the taxpayer sold some of the shares of JISCO to JSL. This transaction also did not reflect the taxpayer's intention to hold the shares and debentures on a long-term basis.

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

- The Tribunal reasoned that the shares of JSL were sold to raise funds to enable the taxpayer to subscribe to the rights issue of PCDs of JISCO. However, there was no cogent material before the Tribunal to arrive at the said conclusion. The taxpayer did not utilise the sale proceeds of the 60,000 JSL shares to subscribe to the PCDs of JISCO but sold the rights to JSL for a fraction of its value.

- None of the taxpayer's actions in the previous year 1991-92 indicated any change in the taxpayer's intention regarding its holding in shares and debentures. The shares in question were held as stock-in-trade. All that happened in the year is that the taxpayer sold substantial shares and renounced its rights to subscribe to PCDs contrary to its stated intention of holding the same on a long-term basis.

- In view of the above, income received by the taxpayer from the sale of shares of JSL and the renunciation of rights to subscribe to the PCDs of JISCO was rightly held by the AO as business income and not income under the head capital gains.

Whether the transaction of renunciation of rights for subscribing to PCDs of JISCO is a colourable device

- The rights to subscribe to the PCDs had been sold by the taxpayer at a price which was significantly lower than the market price. The rights renunciation forms were quoted in the stock market at a price ranging from INR260 to INR280; yet, the taxpayer had sought to transfer the same at a fraction of its market value. Further, the taxpayer had not received the consideration for the same within the relevant financial year. If the business purpose of the taxpayer was to sell one of its assets, it would have done so at the best possible price and terms. However, in the present case, the taxpayer had chosen not to do so.

- It is apparent that the transfer of rights was not for a business purpose. Importantly, the rights were renounced to JSL, which was a related concern. The aforesaid transaction had not resulted in any real loss to the taxpayer. Admittedly, the price paid by the taxpayer for the purchase of shares of JISCO was less than the consideration received by the taxpayer for renouncing its rights to subscribe to PCDs of JISCO.

- Thus, against the cost of acquisition of less than INR10 per share, the taxpayer continued to retain its holding and was also entitled for the apparent sale consideration of INR30 per right to subscribe to a PCD. However, despite not incurring any real loss, the taxpayer had claimed a loss of INR16.86 million for renunciation of its rights to subscribe to 1,29,688 PCDs. The question whether such a loss could be claimed by the taxpayer is a separate matter but, it cannot be disputed that such a loss could at best be described as notional.

- The transaction of renunciation of rights in favour of JSL ensured that the right to subscribe remained within the group. Thus, looking at the transaction at a group level, it is apparent that the right to subscribe to the PCDs and consequently, acquire further shares of JISCO was not alienated and remained within the Jindal Group.

- The only purpose for executing the transactions of renunciation of rights was to contrive a loss and there was no other purpose for entering into the transactions. It is well established that although tax planning is permissible but a colorable device to avoid the payment of tax would be impermissible. Justice Chinnappa Reddy in the case of Mcdowell was of the opinion that it is up to the Court to take stock to determine the nature of new and sophisticated legal devices to avoid tax and expose the same for what they really are and refuse to give 'judicial benediction'. Justice Ranganath Misra speaking for the majority held that tax planning may be legitimate, provided it is within the framework of law.

- In the case of Vodafone International Holdings B.V.[3], the Supreme Court held that the opinion of Justice Chinnappa Reddy must be read in conjunction with the observation of Justice Ranganath Misra. Indisputably, the taxpayer is at liberty to arrange its affairs in a manner so as to mitigate its tax liability. Every action of the taxpayer aimed at reduction of its tax liability cannot be viewed with suspicion by the tax department. The decision in the case of Mcdowell insofar as it relates to the issue of tax avoidance has now been explained to apply only to limited situations where the taxpayer creates a colourable device or enters into a sham transaction to evade tax, which is otherwise payable by him.

- In Sakarlal Balabhai[4], the Gujarat High Court explained the meaning of tax avoidance. Thus, whilst it is settled that the legitimacy of real transactions cannot be questioned merely for the reason that the same result in mitigating the taxpayer's tax liability, the colourable devices or subterfuges to evade tax would be impermissible.

- The Supreme Court in the case of Vodafone International Holdings B.V. accepted the principle that a transaction done without a reasonable

[3] Vodafone International Holdings B.V. v. Union of India and Anr [2012] 341 ITR 1 (SC)
[4] CIT v. Sakarlal Balabhai [1968] 69 ITR 186 (Guj)

purpose but only for the avoidance of legitimate tax by using a corporate form can be ignored. However, in the facts of that case, the Court came to the conclusion that the corporate structure was not created for avoidance of tax but for other genuine business purposes.

- The use of a corporate form to evade tax would be impermissible and it is necessary to look at the transactions entered into by the taxpayer and other companies of the Jindal Group.

- It is clear that shares of the listed corporate entities of the Group were sold and funds were raised. The sale of these shares resulted in substantial capital gains in the hands of the investment companies of the Jindal Group, including the taxpayer and the investment companies were liable to pay tax on the gains so made. In order to avoid paying tax, the investment companies including the taxpayer entered into transactions for renunciation of rights with related companies of the same group. These transactions were for no other business purpose but to contrive a loss in the hands of the companies such as the taxpayer who had incurred a tax liability on account of the gains made.

- In the present case, the transaction of sale of rights entitlement purports to indicate an alienation of a right while in fact at a group level, there has been no alienation of any rights. The transactions have been so executed to ensure that the rights remained within the Jindal Group. Such transactions which are for the sole purpose of contriving a loss cannot be described as anything other than a colourable device.

- In the present case, the facts clearly indicate the transaction to be a part of a scheme, the sole purpose of which is to evade the tax payable on the gains made on the sale of certain shares of JSL. Several companies within the group have adopted a similar stratagem to avoid tax on the gains made by them. Therefore, the loss claimed by the taxpayer was a contrived loss and the transaction of renunciation of rights was a colourable device to claim such a loss.

Determination of the cost of acquisition

- The Bombay High Court in K.A. Patch[5] held that the principles accepted by the Supreme Court for determining the cost of acquisition of a rights entitlement for the purposes of computing capital gains would also be applicable for computing business profits. The High Court did not concur with the same since the commercial and accounting principles for computing trading income/loss are materially different from the principles that may be applied by an ordinary person, who is not a trader, for calculating gains on capital assets.

- In the case of shares held as stock-in- trade, the consideration for the sale of rights entitlement would be a trading receipt which would be credited to the trading account. The cost incurred by the taxpayer would be naturally subsumed in the value of the closing stock, assuming that the shares on the basis of which rights entitlement has been granted to a taxpayer are still retained by him at the end of the closing period.

- In the present case, the taxpayer has admittedly credited the income from the sale of rights entitlement in the profit and loss account. Undisputedly, all costs incurred by the taxpayer as well as the value of closing stock have also been taken into account by the taxpayer.

- Although the taxpayer has sought to transfer the shares of JISCO from stock-in-trade to its investment, it is important to note that such a transfer has also been made on the cost or market price, whichever is lower, the principle on which closing stock-in-trade is valued. Thus, the profit and loss account of the taxpayer would indisputably reflect its income. The same has also been audited.

- There is no scope to provide for a deduction of notional business loss which is neither incurred by the taxpayer nor recorded in its audited books of accounts on the basis of notional costs of acquisition which are neither incurred by the taxpayer, nor form a part of its audited accounts. It would be erroneous to impute notional cost after the taxpayer has drawn up its profit and loss account in accordance with the mandatory accounting standards and in accordance with the provisions of Section 211 of the Companies Act, 1956.

- In case the taxpayer had actually paid the cum rights price of INR625 for purchase of the shares, the reduction in value of the shares on an ex-right basis would be duly reflected in the value of the closing stock. The taxpayer not having paid the price of INR625 cannot claim a loss on account of a drop in its price. Surely, a trader cannot claim that he has lost more than the cost incurred.

- If the taxpayer felt that it was necessary to reduce the value of the shares of JISCO held by it on account of alienation of the rights entitlement, an appropriate proportionate amount could be

[5] CIT v. K.A. Patch [1971] 81 ITR 413 (Bom)

reduced from the cost of the closing stock of its holding on account of the rights issued, or it could do so by proportionally reducing the value of its shareholding in the same proportion as the drop in price of the quoted shares.

Our comments

The Gujarat High Court in the case of Biraj Investment Pvt. Ltd.[6] held that the sale of pledged shares at a loss to a group company which sets-off the gain arising from the transfer of other shares during the same year is not a 'colourable transaction' created for tax avoidance. The High Court held that there is no provision in the Act which would prevent the taxpayer from selling loss making shares. Further, there is no restriction that such a sale cannot be effected with a group company. Simply because such shares were sold during the previous year when the taxpayer had also sold some shares at profit, by itself this instance would not mean that this is a case of a 'colourable device' or that there is a case of tax avoidance.

The Delhi High Court in the instant case has held that in order to avoid paying tax, the taxpayer entered into transactions for renunciation of its rights with related companies of the same group. These transactions were for no other business purpose but to contrive a loss in the hands of the companies. The transaction of the sale of rights is considered as a transaction to purchase taxable losses for the purpose of evading tax. The loss claimed by the taxpayer was a contrived loss and the transaction of renunciation of rights was a colourable device to claim such a loss.

[6] CIT v. Biraj Investment Pvt Ltd [2012] 24 taxmann.com 273 (Guj)

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