Tax Hotline

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SUPREME COURT RECOGNIZES CAPITAL REDUCTION AS EXTINGUISHMENT / RELINQUISHMENT OF RIGHTS, CONFIRMS ELIGIBILITY FOR CAPITAL LOSS CLAIMS

- The Supreme Court affirmed that capital reduction results in the extinguishment or relinquishment of rights, even if percentage shareholding and face value remain unchanged post-reduction.
- Citing judicial precedents, the Court held that capital reduction qualifies as a "transfer," allowing taxpayers to claim tax losses resulting from the reduction.

The Supreme Court has reaffirmed its stance on capital reduction, highlighting that it is extinguishment / relinquishment of taxpayer's rights and falls within the meaning of *"transfer"* as defined under Section 2(47) of the Income-tax Act, 1961 ("**ITA**"). Consequently, taxpayer is entitled to claim long-term capital loss arising from the reduction in shareholding.[1]

TAXATION OF CAPITAL REDUCTION IN INDIA

Capital reduction is a common way to return excess share capital to shareholders. Capital reduction may be undertaken by reducing face value of shares or reducing the outstanding number of shares.[2] Payment of cash consideration pursuant to capital reduction is not mandatory. It is common to give effect to capital reduction by way of book entries.

As per the ITA, proceeds to the extent of accumulated profit distributed on capital reduction is deemed as dividend.[3] Since the ITA does not explicitly include capital reduction within the definition of *'transfer'* for capital gains purposes, there has been considerable controversy regarding whether capital reduction involves the transfer of a capital asset by the shareholders. The Supreme Court in the case of ***Kartikey V. Sarabhai***[4], deliberated upon this issue in context of preference shares. The Supreme Court held that as a result of a reduction in the face value of the share, the share capital is reduced, the right of the shareholder to the dividend and his right to share in the distribution of net assets upon liquidation, are extinguished proportionately to the extent of reduction in the capital. Even though the shareholder remains a shareholder, his right as a holder of those shares stands reduced with the reduction in the share capital. Therefore, this extinguishment of right is 'transfer' exigible to capital gains tax.[5] Subsequently, the Supreme Court in case of G Narasimhan[6] clarified that it is only when any distribution is made which is over and above the accumulated profits of the company the question of a capital receipt in the hands of a shareholder arises. The Supreme Court held that the original cost of the acquisition of that right in the share which stands extinguished as a result of reduction in the share capital will have to be deducted from the capital receipt so determined. As per the Supreme Court decision, only when the capital receipt is in excess of the original cost of the acquisition of that interest which stands extinguished, will any capital gains arise.

KEY FACTS OF THIS CASE

The taxpayer had purchased shares of an Indian company, which subsequently incurred losses, eroding its net worth. As a result, it decided to undergo capital reduction to set off such losses against the paid-up share capital of the company. Following the capital reduction, the taxpayer's shares were proportionately reduced, retaining both the face value of shares and the percentage stake in the company. The taxpayer was also paid a certain sum as consideration for such reduction of share capital.

Revenue's contention

The taxpayer claimed long term capital loss on the reduction in share capital, but this claim was rejected by the revenue. It was argued that since both the face value and the proportionate holding remained unchanged after the capital reduction, the transaction did not constitute a "transfer" under Section 2(47) of the ITA. Therefore, capital gains tax provisions were not applicable, and the consequent long-term capital loss claim could not be allowed.

Supreme Court's decision

Revenue's contention was rejected by the Karnataka High Court on appeal, which led the revenue to approach the Supreme Court. The Supreme Court affirmed the decision of the High Court on the following grounds:

- Relying on **Vania Silk Mills,**[7] the Court observed that the expression "extinguishment of any right therein" in Section 2(47) of the ITA is of broad scope. It encompasses any transaction that results in the destruction, termination, cessation, cancellation, or satisfaction, of all or any part of the bundle of rights (both qualitative and

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quantitative) that a taxpayer holds in a capital asset. The Court therefore held that on account of reduction in the number of shares held by the taxpayer in the Indian company, the taxpayer has extinguished its right of such number of shares.

- Setting out the principles in **Kartikeya v. Sarabhai** (Supra), the Court observed that the relinquishment of rights in a capital asset, even if it does not amount to a sale, can still be considered a transfer as sale is only one of the modes of transfer defined under Section 2(47) of the ITA. Accordingly, the Court held that any profit or gain arising from relinquishment or extinguishment of a right in such a capital asset is also a transfer subject to taxation under Section 45 of the ITA.
- The Court also referred to the decision of **Jaykrishna Harivallabhdas**[8] recognizing that receipt of some consideration in lieu of the extinguishment of rights is not a condition precedent for the computation of capital gains as envisaged under Section 48 of the ITA. Accordingly, capital gains tax provisions can be attracted even in absence of consideration.
- Lastly, reiterating its erstwhile ruling in the case of **Anarkali** (Supra), the Court acknowledged that both reduction of share capital and redemption of shares involve the purchase of its own shares by the company, and hence will be included within the meaning of transfer under Section 2(47) of the ITA.

On basis of the above, the Supreme Court rejected the revenue's argument and held that the reduction in share capital of the subsidiary company and subsequent proportionate reduction in the shareholding of the taxpayer would be squarely covered within the ambit of the expression “sale, exchange or relinquishment of the asset” used in Section 2(47) the ITA. Hence, the taxpayer’s claim of long-term capital losses arising on capital reduction was allowed.

NDA COMMENTS

While the Supreme Court has ruled in favor of the taxpayer, the reasoning adopted by it is not very clear (even questionable). The decision of the Supreme Court is not clear on whether proportionate reduction of share capital will qualify as ‘relinquishment of asset’ or ‘extinguishment of right therein’. While the transaction will qualify as a ‘transfer’ irrespective of whether it is relinquishment of asset or extinguishment of right therein, the decision may set precedent for potentially vague interpretations. In the past, the Supreme Court has held redemption of shares to be relinquishment of asset[9] and reduction of face value of shares to extinguishment of rights therein.[10]

Secondly, it is not clear why the Court has relied on earlier its decisions which were in context of preference shares. Preference shareholders and equity shareholders are inherently different in nature. Preference shareholders have right to receive dividend and preferential right on liquidation of company. On the contrary, equity shareholders have voting rights and right to receive its share of residual surplus during liquidation.

Several other cases have ruled on allowability of loss on proportionate capital reduction. The Mumbai Tribunal in case of *Tata Sons Ltd vs CIT*[11] held that reduction of capital amounts to extinguishment of rights on the shares and loss on reduction of shares is a capital loss (not a notional loss) and should be allowed irrespective of whether there is consideration or not. The Mumbai Tribunal has distinguished the earlier decision of the Special Bench of Mumbai Tribunal[12] on factual grounds. Certain aspects which were considered in the other cases *inter-alia* involved whether consideration was paid pursuant to capital reduction or not,[13] interplay of exemption under section 47(iv) and allowability of capital loss[14] etc. It would have been worthwhile to see the Supreme Court analyze the jurisprudence which has developed over the year on the issue of allowability of capital loss on capital reduction.

Buyback is another way of purchase its own capital by companies. Finance Act, 2024 made some significant changes to the framework of taxation of buybacks. On the aspect of allowability of capital loss, if one were to compare buyback and capital reduction, one could argue that buyback offers more certainty on allowability of loss considering section 46A deems the sale consideration to be nil. Whether a company chooses to do buyback or capital reduction may depends on facts of the case, however, considering the litigation on allowability of loss on capital reduction, it may be useful to compare benefits of buyback vis-a-vis capital reduction.

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You can direct your queries or comments to the relevant member.

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[1]PCIT vs, Jupiter Capital Pvt. Ltd. [SLP 63 of 2025]

[2]Section 66 of the Companies Act, 2013

[3]Section 2(22)

[4][1997] 228 ITR 163 (SC)

[5]The Supreme Court relied on its earlier ruling in case of Anarkali Sarbhai vs CIT [1997] 224 ITR 422 (SC). In this case, the taxpayer had redeemed preference shares and received consideration in excess of face value. Supreme Court held that such redemption would squarely fall within ambit of ‘sale, exchange or relinquishment of asset’.

[6]CIT v. G. Narasimhan [1999] 236 ITR 327 (SC)

[7]CIT vs. Vania Silk Mills [1977] 107 ITR 300. This decision was rejected by the Supreme Court on appeal [(1991) 191 ITR 647 (SC)], which was later reversed in the case of CIT vs. Grace Colls [2001] 248 ITR 323 (SC), restoring the position held by the Gujarat High Court.

[8] (1998) 231 ITR 108 (Gujarat High Court)

[9][(1982) 138 ITR 437 (Guj)]

[10][1997] 228 ITR 163 (SC)

[11][2024] 115 ITR(T) 272 (Mumbai -Trib.)

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[12] Bennett Coleman and Co. Ltd. v. Addl. CIT 2011(9) TMI-ITAT; The Special Bench held that capital loss on capital reduction should not be allowed as there was no consideration received by the shareholder

[13] Ginners & Pressers Ltd. v. ITO [IT Appeal No.3981 (Mum.) of 2007; Carestream Health INC. v. Dy. CIT [IT Appeal No. 826(Mum.) of 2016

[14] ITA No 1449 / Mum/ 2016
