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Essar Teleholdings Case - Would it Pass the Test of GAAR?

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Introduction

The Mumbai bench of the Income Tax Appellate Tribunal (Tribunal), in the recent case of *Essar Teleholdings Limited* (Taxpayer), has allowed the Taxpayer's claim for set-off of short term capital loss (Loss) on sale of compulsory convertible debentures (CCDs) to its holding company (Hold Co) against long term capital gains earned on sale of shares. The Tribunal reversed the orders of the tax authorities who had denied the Taxpayer's claim by holding that the transaction was not bonafide and was a 'colourable device'.

Facts

In the financial year 2010-11, the Taxpayer purchased CCDs of an unlisted company (Target) from its wholly owned subsidiary company (Subsidiary) at INR 85 per CCD which was approved by the High Court in a scheme of merger. Seven months later, the Taxpayer sold these CCDs to its Hold Co at a price of INR 61.88 per CCD, thus incurring a Loss of approximately INR 70 crores. While arriving at the sale price of the CCDs, a discount on account of illiquidity of the CCDs was factored in; however, the same was not considered while arriving at the purchase price. Two days after this sale of CCDs by the Taxpayer, the Taxpayer sold certain equity shares and preference shares in the open market resulting in long term capital gains (Gains) of ~INR 1007 Crores. The Taxpayer sought to set-off the Loss of INR 70 crores against the Gains of INR 1,007 crores (Set-off Claim). For transfer of capital assets inter se wholly owned (100%) parent and subsidiary entities, the Income Tax Act, 1961 (IT Act) provides an exemption in relation to gains earned on the transfer and accordingly, losses arising on such transfers are also not available for set-off against other gains. In the instant case, as the Hold Co was not a 100% shareholder of the Subsidiary, there was no bar under the IT Act on set-off of Loss arising on transfer of CCDs between the two entities.

During assessment proceedings, the Taxpayer's Set-off Claim was disallowed by the tax authorities for *inter alia* the following reasons, despite the Taxpayer contending that it had other tax losses also against which the Gains could have been set-off:

- Both purchase and sale of CCDs by the Taxpayer were from and to 'closely related concerns', being the Subsidiary and Hold Co, respectively;
- No valuation report was obtained by the Taxpayer to arrive at the purchase price for CCDs as on the date of purchase of CCDs by the Taxpayer from its Subsidiary;
- Inconsistency in the valuation approach as no discount on account of illiquidity of the CCDs was factored in while calculating the purchase price, but such discount was considered while arriving at the sale price of the CCDs;
- Failure to commercially justify sale of CCDs at a substantial loss within a seven-month period; and
- Timing of the sale of CCDs being two days prior to the Gains earned by the Taxpayer on the sale of shares.

Ruling of the Tribunal

The Tribunal ruled in favour of the Taxpayer and allowed the Set-off Claim. On the aspect of 'colourable device', the Tribunal noted that the sale price of the CCDs had been arrived at by an independent Chartered Accountant after applying a discount (on account of their illiquidity) since the Target was not a listed company, and such discount had a strong and rational basis. The Tribunal observed that the sale price adopted by the Taxpayer was in fact higher than the fair market value of the CCDs on the date of sale and hence, the transaction could not be a 'colourable device'.

As regards the purchase price, the Tribunal noted that the Taxpayer had purchased the CCDs from its

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Subsidiary, which had in turn purchased the CCDs from its subsidiary at a price of INR 85 per CCD. The Taxpayer's consideration of INR 85 per CCD was thus governed by commercial considerations of ensuring that the Subsidiary and the step-down subsidiary do not incur any loss on their investments. Further, since this price of INR 85 per CCD had been approved by the High Court in a scheme of merger, the Tribunal held that the purchase price of INR 85 per CCD could not be construed as a 'colourable device'.

As regards the timing of the transactions, the Tribunal ruled that the sale of shares resulting in Gains had taken place after the sale of CCDs resulting in Loss and hence, the same cannot be viewed with a jaundiced eye, merely because the Loss had arisen out of transactions with a related concern and the coincidental nearness of the two transaction dates. The Tribunal ruled that the transactions were independent, and it was for the Taxpayer to decide when to sell the CCDs and the shares, and that the revenue cannot step into the shoes of the Taxpayer in this regard.

Comments

A key takeaway from this ruling is the acceptance of 'commercial rationale' as a valid reason for a loss-making transaction between related parties. In the instant case, the Tribunal has upheld that a transaction between a holding and a subsidiary company that is structured in a manner to ensure that the subsidiary company does not incur any loss on the said transaction is commercially expedient and not a 'colourable device'.

Interestingly, while this argument of the Taxpayer has been accepted, it is unclear as to why the same test was not applied in relation to sale of CCDs to the Hold Co, i.e. if the principle of 'commercial expediency' were to be uniformly applied, then, it could also have been tested as to why the Hold Co of the Taxpayer did not purchase the shares in a manner to ensure that its subsidiary (the Taxpayer) did not incur a loss.

Though this ruling dealt with a period when the IT Act did not have a codified General Anti Avoidance Rules (GAAR) in place (which permits the tax authorities to tax a transaction based on its substance, rather than mere form), the tax authorities sought to question the commercial rationale of the series of transactions and viewed them as a 'colourable device'. If a similar transaction were to occur in the GAAR regime, it would be interesting to analyse whether it would pass the test of GAAR, especially considering that (i) the transactions were between related parties, (ii) they were carried out as a series of transactions in quick succession, and (iii) there was no valuation report to support the purchase price of the Taxpayer.

The article also has inputs from Jugal Mundra (Associate).

The views of the authors in this article are personal and do not constitute legal / professional advice of Khaitan & Co. For any further queries or follow up please contact us at editors@khaitanco.com.