IN THE INCOME TAX APPELLATE TRIBUNAL
"F" Bench, Mumbai

Before Shri Jason P. Boaz, Accountant Member
and Shri Sandeep Gosain, Judicial Member

ITA No. 4669/Mum/2014
(Assessment Year: 2005-06)

Shri Uday K. Pradhan 1st Floor, Parijat Apt. Opp. Lilavati Hospital Bandra Reclamation Bandra (W), Mubai 400050	Vs.	Income Tax Officer-26(2)-3 Ayurved Prachar Sanstah Bldg., Charni Road Mumbai 400002
PAN - AAAPP6068R		
Appellant		**Respondent**

Assessee by: Shri Dharmesh Shah
Revenue by: Shri Sandeep Goel

Date of Hearing: 31.03.2016
Date of Pronouncement: 06.04.2016

O R D E R

Per Jason P. Boaz, A.M.

This appeal by the assessee is directed against the order of the CIT(A)-28, Mumbai dated 13.05.2014 for A.Y. 2005-06.

2. The facts of the case, in brief, are as under: -

2.1 The assessee was a partner in a firm which was converted to a company, M/s. Enviro Control Associates India (P) Ltd. For A.Y. 2005-06, the assessee filed its return of income on 29.12.2005 declaring total income of ₹52,519/-. The case was taken up for scrutiny and the assessment was completed under section 143(3) r.w.s. 147 of the Act vide order dated 14.12.2007; wherein the income of the assessee was determined at ₹26,20,479/- in view of the addition of ₹20,74,170/0 under section 2(22)(d) of the Act on account of deemed dividend.

2.2 Aggrieved by the order of assessment for A.Y. 2005-06 dated 14.12.2007, the assessee preferred an appeal before the CIT(A). On further appeal by the assessee, the Coordinate Bench of this Tribunal in its order in

ITA No. 8758/Mum/2011 dated 08.01.2014 allowed the assessee's appeal for statistical purposes by remanding the matter to the file of learned CIT(A) for adjudication afresh after affording adequate opportunity of being heard to the assessee.

2.3 In the second round, the learned CIT(A), after considering the assessee's submission put forth vide letter dated 06.05.2014, upheld the action of the Assessing Officer (AO) in treating the amount of ₹20,74,170/- received by the assessee on redemption of preference shares as dividend under section 2(22)(d) of the Act. The learned CIT(A) accordingly dismissed the assessee's appeal vide the impugned order dated 13.05.2014.

3. Aggrieved by the order of the CIT(A)-28, Mumbai dated 13.05.2014 for A.Y. 2005-06, the assessee has preferred this appeal raising the following grounds: -

> *"1. The Learned Commissioner of Income-Tax (Appeals) has erred in Law and facts in passing the order u/s. 250 of the Act.*
>
> *2. The Learned Commissioner of Income-Tax (Appeals) has erred in law and in facts in confirming the addition of Rs.20,74,170/- on account of dividend u/s. 2(22)(d) of the Act on redemption of preference shares.*
>
> *3. The learned Commissioner of Income-Tax (Appeals) has erred in upholding the order of the Assessing Officer in treating the said amount of Rs.20,74,170/- as income without appreciating that the redemption is made out of original amount of shares allotted to the assessee for a valuable consideration.*
>
> *4. The learned Commissioner of Income-Tax (Appeals) has failed to appreciate that the redemption of preference shares do not result into distribution of assets as reduction of capital as stated in S. 2(22)(d) of the Act.*
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> *5. The appellant craves Leave of Your Honour to add to, alter, amend and/ or delete all or any of the foregoing grounds of appeal."*

4.1 In addition thereto, the assessee has alternatively raised the following additional grounds: -

> *"1. The Ld. CIT(A) has erred in law and in facts in not appreciating that the dividend of Rs.20,74,170/- u /s 2(22)(d) of the Act is exempt in the hands of the appellant.*
>
> *2. The appellant craves leave to add, amend, alter or delete any or all grounds of appeal."*

4.2 It is submitted by the learned A.R. for the assessee that alternatively in the additional grounds raised and without prejudice to the ground raised at Sr. Nos. 1 to 5 (supra), the assessee submits that even if the provisions of section 2(22)(d) of the Act were held applicable, the amount of dividend would be exempt from tax in view of the provisions of section 10(34) of the Act. It was prayed that even though the same were not raised by the assessee in the original grounds filed, but the same may be admitted and adjudicated upon since this is a legal issue which goes to the root of the matter and all facts in the matter are available on record and no further investigation of facts is required. In support of this proposition, the assessee has placed reliance on the following judicial pronouncements: -

(i) NTPC vs. CIT (229 ITR 383) (SC)
(ii) Jute Corporation of India vs. CIT (187 ITR 688) (SC)
(iii) Ahmadabad Electricity Co. Ltd. vs. CIT 199 ITR 351 (Bom) (FB)

4.3 We have heard the rival contentions of both the learned A.R. for the assessee and the learned D.R. for Revenue in the context of admission of the additional grounds raised by the assessee. We are of the opinion that since the additional grounds raised (supra) pertain to legal issue that goes to the root of the matter and that all facts in the matter already form part of the record, the same may be admitted for consideration and adjudication in the interest of justice and equity. We accordingly admit the additional grounds raised by the assessee for consideration and adjudication in this appeal.

5. **Grounds of appeal at S.Nos. 1 to 5: Addition under section 2(22)(d) on account of Redemption of Preference Shares - ₹20,74,170/-**

5.1.1 In the above grounds, the assessee assails the impugned order of the learned CIT(A) in upholding the addition of ₹20,74,170/- made by the AO on account of dividend under section 2(22)(d) of the Act on redemption of preference shares without appreciating that the redemption is made out of original amount of shares allotted and that such redemption does not result in distribution of assets to constitute reduction of capital as stated in

section 2(22)(d) of the Act. The learned A.R. for the assessee reiterated the submission put forth before the learned CIT(A). It was contended that the said redeemable preference shares numbering 2,07,417 received by the assessee were against valuable consideration, i.e. against the outstanding credit capital balance lying with the erstwhile firm in which the assessee was a partner and which was later on converted into a private limited company. It was also contended that the redemption is made out of the original amount of shares allotted to the assessee for valuable consideration and therefore there is no distribution of any profit by the company to its shareholder on redemption of preference shares. It is further contended that in the case on hand the provisions of section 2(22)(d) of the Act which is in respect of deemed distribution of profits to its shareholders by a company on reduction of its capital to the extent to which the company has accumulated profits, is not applicable once the assessee was allotted the aforementioned redeemable preference shares in lieu of the capital credit balance of ₹38,74,178/- with the erstwhile firm which was converted into the above mentioned company, i.e. M/s. Enviro Control Associate Pvt. Ltd. The learned A.R. for the assessee submitted that in the factual matrix of the case as submitted above it was clear that there is no distribution of any profit by the company to its shareholders or reduction in authorised share capital on the redemption of the aforesaid preference shares and therefore the provisions of section 2(22)(d) of the Act are not applicable in the case on hand.

5.1.2 In support of the above proposition that the sale of the aforesaid preference shares, in the factual matrix of the case on hand did not result in reduction of share capital and therefore would not attract the provisions of section 2(22)(d) of the Act, the learned A.R. for the assessee placed reliance, inter alia, on the following judicial pronouncements of the ITAT Mumbai in the case of Parle Biscuits Pvt. Ltd. in ITA Nos. 5318 & 5319/Mum/2006 and ITA 447/Mum/2009 and others dated 19,08.2011, wherein after considering the very same issue of the effect of sale of preference shares on reduction of share capital, the Coordinate Bench had held that by virtue of section 80(3) of the Companies Act the redemption of preference shares cannot be considered as reduction of the company's authorised share capital and

therefore redemption cannot be treated as deemed dividend as the provisions of section 2(22)(d) of the Act can be invoked only when there is a distribution of accumulated profits by way of reduction of share capital.

5.2 Per contra, the learned D.R. for Revenue supported the impugned order of the learned CIT(A). It was submitted that the learned CIT(A), after considering the assessee's submissions and also the provisions of section 80(3) and 100 of the Companies Act, 1956 and section 2(22)(d) of the Act held that redemption of preference shares amounts to reduction of capital. The learned D.R. further submitted that the learned CIT(A) was correctly of the view that since no payment had been made by the assessee towards acquisition of the redeemable preference shares allotted to him, this amounted to reduction in share capital and accordingly the amount received by the assessee on redemption of the redeemable preference shares amounted to receipt of dividend and the provisions of section 2(22)(d) of the Act would apply in the case on hand.

5.3 In rejoinder, the learned A.R. for the assessee pointed out that the redeemable preference shares received by the assessee were not received free of cost as contended but were received in lieu of the assessee's credit balance lying with the erstwhile firm which was converted/corporatized into a company.

5.4.1 We have heard the rival contentions of both the parties and perused and carefully considered the material on record; including the judicial pronouncement cited. The facts of the matter as emanate from the record are that the assessee was a partner in the firm which was converted into a company, i.e. M/s. Enviro Control Associates India P. Ltd. Admittedly as per the books of the erstwhile firm, the assessee had a credit balance of ₹38,74,178/- as on 31.03.2001 and in lieu of the said credit balance the assessee, for this value consideration, received two lakhs equity shares and 2,07,417 redeemable preference shares. In the year under consideration, i.e. on 18.06.2004, the said redeemable preference shares were redeemed at par, i.e. ₹10/- and the assessee received ₹20,74,170/-. The AO, on examination thereof, was of the view that the assessee's receipt of the sum

of ₹20,74,170/- on redemption of preference shares resulted in reduction of the authorised share capital and invoked the provisions of section 2(22)(d) of the Act to bring the same to tax as deemed dividend. On appeal, the learned CIT(A) was of the view that this was a colourable device for distribution of accumulated profits without any payment by the assessee and which benefitted the assessee/shareholder to the tune of ₹20,74,170/- and was exigible to tax under section 2(22)(d). On further appeal, the Coordinate Bench of the Tribunal remanded the matter to the file of the learned CIT(A) for fresh consideration and adjudication after affording the assessee adequate opportunity of bring heard.

5.4.2 In the impugned order, the learned CIT(A) after considering the submissions made and the provisions of section 80(3) and 100 of the Companies Act, 1956 held that since no payment had been made by the assessee towards acquisition of the redeemable preference shares allotted to him, this amounted to reduction in share capital and therefore the amount of ₹20,74,170/- received by him on redemption thereof was deemed dividend under section 2(22)(d) of the Act. We find that as per the record it is evident that the assessee received the 2,07,417 redeemable preference shares in lieu of his credit capital balance of ₹38,74,178/- in the erstwhile firm which had since been corporatized. In short, it is clear that the assessee was allotted the aforesaid redeemable preference for valuable consideration. In this factual matrix, it is evidently clear that there is no distribution of accumulated profits by the company to its shareholders by redemption of the preference shares at par resulting in reduction of authorised share capital and therefore the provisions of section 2(22)(d) of the Act would not apply in the case on hand. Section 80(3) of the Companies Act, 1956 states that the redemption of preference shares cannot be considered as reduction of authorised share capital and therefore treating the same as deemed dividend under section 2(22)(d) of the Act does not arise as the same can be invoked only when there is distribution of accumulated profits by way of reduction of share capital.

5.4.3 In coming to this finding we draw support from the decision of the Coordinate Bench of this Tribunal in the case of Parle Biscuits Pvt. Ltd. in ITA Nos. 5318 & 5319/Mum/2008 and 447/Mum/2009 dated 19.08.2001 wherein in a similar factual situation the Coordinate Bench had held that since in the facts of the case there is no reduction of authorised share capital as per the provisions of section 80(3) of the Companies Act, 1956 which states that redemption of preference shares shall not be taken as reducing its authorised share capital, that part of the amount received by the assessee at face value does not fall within the definition of deemed dividend under section 2(22)(d) of the Act and therefore cannot be treated as such. At paras 37 to 43 of its order, the Coordinate Bench of this Tribunal has held as under: -

> *"37. We have considered the issue. As far as redeeming preference shares are concerned, the Hon'ble Supreme Court in the case of Anarkali Sarabhai vs. CIT 224 ITR 422 has examined the provisions of section 77 of the Companies Act, section 80 of that Act and also definition of transfer under section 2(47) of IT ACT and has held that the difference between the sum received by the assessee on redemption of shares and the sum earlier paid by for purchasing them was taxable as capital gain. The decision of the Hon'ble Supreme Court is as under: -*
>
> *"When a preference share is redeemed by a company, what the shareholder does in effect is to sell the hare to the company. The company redeems its preference shares only by paying the preference shareholders the value of the shares and taking back the preference shares. In effect, the company buys back the preference shares from the shareholders. If redemption of preference shares did not amount to sale, it would not have been necessary, in section 77 of the Companies Act, 1956, to specifically provide that the restriction imposed upon a company in respect of buying its own shares will not apply to redemption of shares issued under section 80 of that Act. The redemption of preference shares by a company, therefore, is a sale and squarely comes within the phrase "sale, exchange or relinquishment" of an asset in section 2(47)(i) of the Income-tax Act, 1961."*
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> *The definition of "transfer" in section 2(47) of the Income-tax Act, 1961, is not an exhaustive definition. Sub-clause (i) of clause (47) of section 2 speaks of "sale, exchange or relinquishment of the asset" and implies parting with any capital asset for gain which will be taxable under section 45 of the Act. When preference shares are redeemed by the company, the shareholder has to abandon or surrender the shares, in order to get the amount of money in lieu thereof. There is, therefore, also a relinquishment which brings the transaction within the meaning of section 2(47)(i) of the Income-tax Act.*
>
> *The appellant had purchased preference shares in a company at less than their face value and held them as capital assets. The company redeemed them at their face value:*

Held accordingly, that the difference between the sum received by the appellant on redemption of the shares and the sum earlier paid by her for purchasing them, was taxable as capital gains."

38. Similar issue was also considered by Hon'ble Supreme Court in the case of Kartikeya Sarabhai vs. CIT 228 ITR 163 where there is reduction in face value of shares, the definition of transfer were discussed and held as under: -

"Section 2(47) of the Income-tax Act, 1961, defines "transfer" in relation to a capital asset. It is an inclusive definition which, inter alia, provides that relinquishment of an asset or extinguishment of any right therein amounts to a transfer of a capital asset. It is not necessary for a capital gain to arise, that there must be a sale of a capital asset. Sale is only one of the modes of transfer envisaged by section 2(47) of the Act. Relinquishment of the asset or extinguishment of any right in it, which may not amount to a sale, can also be considered as a transfer and any profit or gain which arises from the transfer of a capital assist is liable to be taxed under section 45. A company, under section 100(1)(c) of the Companies Act, 1956, has a right to reduce the share capital and one of the modes which can be adopted is to reduce the face value of the preference shares. Section 87(2)(c) of the Companies Act, inter alia, provides that "where the holder of any preference share has a right to vote on any resolution in accordance with the provisions of this sub-section, his voting right on a poll, as the holder of such shares, shall, subject to the provisions of section 89 and sub-section (2) of section 92, be in the same proportion as the capital paid up in respect of the preference share bears to the total paid-up equity capital of the company". Hence, when as a result of the reducing of the face value of the share, the share capital is reduced, the right of the preference shareholder to the dividend on his share capital and the right to share I the distribution of the net assets upon liquidation is extinguished proportionately to the extent of reduction in the capital. Such reduction of the right in the capital asset would clearly amount to a transfer within the meaning of that expression in section 2(47) of the Income-tax Act, 1961."

39. Consequently, the redeeming of preference shares has to be considered as a transfer under the meaning of section 2(47). Therefore computation of capital loss has to be considered on this transaction. Assessee has worked the cost of acquisition as per the provisions of section 48 and since shares was held for more than one year and being a long term capital asset, indexed cost of acquisition has been claimed as against the sale consideration received. On the facts of the case, assessee purchased preference shares at a cost of ₹2 crores and the same was redeemed at face value and assessee received only ₹2 crores. However, by virtue of mode of computation prescribed under section 48 of the I.T. Act assessee's sale consideration being ₹2 crores and indexed cost of acquisition being ₹2,35,58,718/- being the deduction allowable under section 48, the net loss of ₹35,58,718/- has been computed. This amount is an allowable long term capital loss.

40. The A.O., however, examined the issue of section 2(22)(d). Provisions of section of section 2(22)(d) are as under: -

" 2(22) ……

…….

(d) any distribution to its shareholders by a company on the reduction of its capital, to the extent to which the company possesses accumulated profits which arose after the end of the previous year ending next before the 1st day of April, 1933, whether such accumulated profits have been capitalised or not ;"

41. As can be seen by the above provision, there should be a reduction of its capital and distribution to the shareholders out of the accumulated profits. Section 80(3) of the Companies Act states that the redemption of preference shares under this section by a company shall not be taken as reducing the amount of its authorised share capital. By virtue of section 80(3) redemption of preference shares cannot be considered as reduction of authorised share capital, therefore, treating them as deemed dividend does not arise, as the provisions of section 2(22)(d) can only be invoked only when there is distribution of accumulated profits by way of reduction of share capital. On the facts of the case, assessee has purchased the preferential shares at a cost of ₹2 crores and they were redeemed at the same price of ₹2 crores. Therefore the question of invoking deemed dividend provision on this transaction does not arise, eventhough the redemption of shares are to be made out of the profits of the company by virtue of section 80(1) of the Companies Act. However, since it cannot be treated as reduction of authorised share capital by virtue of section 80(3) of the Companies Act, the amount received by assessee on redemption of preference shares cannot be treated as deemed dividend. The A.O. relied on the principles established by the Hon'ble Supreme Court in the case of CIT vs. G. Narasimham & Others 236 ITR 327. In fact this case supports the above opinion also eventhough it was given in a different context. The facts of that case were that assessee was a shareholder in a private company. Assessee held 70 shares in the company with face value of ₹1,000/- each. During the accounting period relevant to A.Y. 1963-64 the company passed a resolution to reduce its capital and the procedure prescribed under the Companies Act was undergone. After obtaining the orders from the Court reduction was given effect and on 26.05.1962. Subsequently the face value of shares in the company was reduced from ₹1,000/- to ₹210/-. There was a pro-rata distribution of some properties of the company and payment of money to the shareholders including the assessee. In the Income Tax proceedings connected with the property/amounts so received by the assessee on reduction of share capital in the said company, the Tribunal was required to consider whether any capital gains accrued to the assessee. The Tribunal held that no capital gain accrued to the assessee. The Hon'ble High Court held that a sum of ₹64,517/- must be taken to have come out of the accumulated profits and treated as dividend for all purpose and on appeal the Hon'ble Supreme Court confirmed the decision of the Hon'ble Madras High Court and held that: -

"(ii) that the assessee in the present case had been paid not merely cash but had also been given a property for the reduction in the value of his shares from ₹1,000 to ₹210. Out of the total amounts so received including the value of the property so received, the portion attributable to accumulated profits had to be deleted. Only the balance amount could be treated as a capital receipt.

Thereafter looking to the cost of acquisition of that portion of the share which had been diminished, capital gains would have to be determined. The Tribunal, while computing capital gains, would have to decide how this property should be valued for the purpose of deciding what the assessee had received on reduction in the value of his shares, and whether any capital gains had accrued to the assessee or not. This question was not required to be considered by the Tribunal because the Tribunal came to the conclusion that there being no transfer of any capital asset, the question of capital gains did not arise. But the question would now have to be considered and decided by the Tribunal when the matter went back before it for the determination of capital gains."

42. It was further held that thus the amount distributed by a company on reduction of its share capital has two components, i.e. distribution attributable to accumulated profits and distribution attributable to capital (except capitalised profits). To the extent of accumulated profits whether such accumulated profits are capitalised or not, the return to the shareholder on reduction of share capital is a return of such accumulated profits. This part of it is taxable as dividend. The balance may be subject to tax as capital gain, if they accrue.

43. Adopting the same principles here, since there is no reduction of share capital in the given case, consequent to section 80(3) of the Companies Act which states that redemption of preference shares under this section shall not be taken as reducing the amount of its authorised share capital, that part of the amount received by assessee as face value, eventhough paid out of accumulated profit, does not fall within the definition of deemed dividend, therefore, cannot be treated as deemed dividend."

5.4.4 Respectfully following the decision of the Coordinate Bench of this Tribunal in the case of Parle Biscuits Pvt. Ltd. in ITA Nos. 5318 & 5319/Mum/2008 and 447/Mum/2009 dated 19.08.2001, which is factually and legally similar and therefore applicable in the factual and legal matrix of the case on hand, we hold that in terms of section 80(3) of the Companies Act, 1956, there is no reduction in the authorised share capital of the company, M.s Enviro Control Associates India Pvt. Ltd. by virtue of the redemption of the aforesaid preference shares at face value, which were acquired by the assessee for valuable consideration in lieu of its credit balance in his capital account with the erstwhile firm and therefore this amount of ₹20,74,170/- does not fall within the definition of deemed dividend under section 2(22)(d) of the Act and cannot be treated as such. We, therefore, delete this addition made under section 2(22)(d) of the Act by the AO and upheld by the learned CIT(A) as the same is factually unsustainable. Consequently, the grounds raised by the assessee at S.Nos. 1 to 5 are allowed.

6. Since the assessee's grievance has been addressed by deletion of the addition made under section 2(22)(d) of the Act by the authorities below (supra), we do not deem it necessary to adjudicate the additional grounds S.Nos. 1 & 2 raised by the assessee (supra).

7. In the result, the assessee's appeal for A.Y. 2005-06 is allowed.

Order pronounced in the open court on 6th April, 2016.

Sd/-	Sd/-
(Sandeep Gosain)	**(Jason P. Boaz)**
Judicial Member	**Accountant Member**

Mumbai, Dated: 6th April, 2016

Copy to:

1. *The Appellant*
2. *The Respondent*
3. *The CIT(A) -28, Mumbai*
4. *The CIT - 26, Mumbai*
5. *The DR, "F" Bench, ITAT, Mumbai*

By Order

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Assistant Registrar
ITAT, Mumbai Benches, Mumbai

n.p.