CIT -vs.- Walfort Share & Stock Pvt. Ltd.

Sec. 94(7) of the Income-tax Act, 1961

Under sec.94(7), the loss to be ignored would be only to the extent of the dividend received and not the entire loss .

A. The facts in the lead matter are as follow:

1) The assessee is a member of Bombay Stock Exchange and it earns income mainly from share trading and brokerage.
2) During the financial year 1999-2000, relevant to the assessment year 2000-01, the Chola Freedom Technology Mutual Fund came out with an advertisement stating that tax free dividend income of 40% could be earned if investments were made before the record date, i.e., 24.3.2000
3) The assessee by virtue of its purchase on 24.3.2000 became entitled to the dividend on the units at the rate of Rs. 4/- per unit and earned a dividend of Rs. 1,82,12,862.80
4) As a result of the dividend payout, the NAV of the said mutual fund which was Rs. 17.23 per unit on 24.3.2000, at which rate it was purchased, stood reduced to Rs. 13.23 per unit on 27.3.2000, which was the succeeding working day in the stock exchange.
5) This fall in the NAV was equal to the amount of the dividend payout
6) The assessee sold all the units on 27.3.2000 at the NAV of Rs. 13.23 per unit and collected an amount of Rs. 5,90,55,207.75.
7) The assessee also received an incentive of Rs. 23,76,778/- in respect of the said transaction.
8) Thus, the assessee thereby received back Rs. 7,96,44,847 (Rs. 1,82,12,862.80 + Rs. 5,90,55,207.75 + Rs. 23,76,778) against the initial payout of Rs. 8,00,00,000/-.
9) For the income tax purposes, the assessee, in its return, claimed the dividend received of Rs. 1,82,12,862.80 as exempt from tax under Section 10(33) of the Income Tax Act, 1961 ("the Act" for short) and also claimed a set-off of Rs. 2,09,44,793 as loss incurred on the sale of the units thereby seeking to reduce its overall tax liability.

B. Steps taken by Assessing Officer

1) The AO in his assessment order dated 21.3.2003 accepted that the dividend income amounting to Rs. 1,82,12,862.80 was exempt under Section 10(33) of the Act.
2) However, the AO disallowed the loss of Rs. 2,09,44,793 claimed by the assessee inter alia on the ground that a dividend stripping transaction was not a business transaction and since such a transaction was primarily for the purpose of tax avoidance, the loss so- called was an artificial loss created by a pre-designed set of transaction.
3) Accordingly, the AO deducted the incentive income of Rs. 23,76,778 received by the assessee + transaction charges from the loss of Rs. 2,09,44,793 and added back the reduced loss of Rs. 1,82,12,862.80
4) In other words, by the impugned orders passed by the AO, the Department sought to tax the dividend income of the assessee during the relevant assessment year of Rs. 1,82,12,862.80

C. Question arises from the Order of AO

Whether the loss arising in the course of dividend stripping transaction taking place prior to 1.4.2002 [before insertion of Section 94(7)] was disallowable on the ground that such loss was artificial as the dividend stripping transaction was not a business transaction.

D. Order of CIT(A)-In favor of Department

The assessee filed an appeal before CIT(A) who by his order dated 12.12.2003 confirmed the order of the AO saying that the loss of Rs. 1,82,12,862.80 incurred by the assessee on the sale of units should be totally ignored and that the same should not be allowed to be set-off or carried forward.

E. Order of ITAT-In favor of Assessee

The disallowance stood deleted by the Special Bench of the Tribunal vide its impugned order dated 15.7.2005 by holding that the assessee was entitled to set-off the said loss from the impugned transactions against its other income chargeable to tax.

F. Department moved to High Court

The view of the tribunal has been affirmed by the High Court vide its impugned judgment dated 8.8.2008

G. Department moved to Supreme Court by SLP

The contention of department before Honorable Supreme court-

1) The amount received by the assessee as "dividend", in fact and in law, constitutes a "return of investment" therefore, it follows that the said amount is required to be *adjusted against the cost of purchase* of the original units and once that is done there is in fact no loss suffered by the assessee on subsequent sale/ redemption.[Honorable SC was not agree on this point - pls see-J(1)(VI)]
2) *Alternatively*, if the so-called "dividend" did not constitute a return of investment, then since *the price of units necessarily included the price of dividend* as an identifiable element embedded therein to which a definite value could be assigned at the time of the purchase, the "dividend" is in effect "paid for".
   In such circumstances *that part of the price of units* which clearly represented the cost of the dividend, *is the expenditure incurred for obtaining exempt income* and if that is the case then *Section 14A* requires that such expenditure should be netted against the receipt of dividend. [Honorable SC was not agree on this point - pls see j (1) (I to V)]
3) *Two assets theory-*
   The effect of the newspaper advertisements (by the mutual fund) is to segregate the unit into two assets, namely,
   1-the asset of the tax free dividend and
   2-the ex-dividend unit which will have an NAV reduced by the amount of the dividend payout per unit.
   Since there are two assets which are sold to the buyer of the cum-dividend units, it follows that the *difference between the purchase and sale price of the unit, is nothing but the expenditure incurred for purchasing the asset of tax free dividend*. [Honorable SC was not agree on this point - pls see j (1) (I to V)]

4) In any event *"loss" is a commercial concept* under the Act, if a transaction is such that a *"tax loss" is created* or contrived *without suffering any corresponding financial / commercial loss* inasmuch as the money has in fact been recouped in

some other form (such as dividend), then *such a loss needs to be ignored for tax purposes.* [Honorable SC was not agree on this point - pls see-J(2)]

5) This is because such a loss, not being a "commercial loss", was never intended to be allowed under the Act. [for SC answer pls see-J(2)]
6) Introduction of Section 94(7) prospectively w.e.f. 1.4.2002 does not obliterate the aforementioned last submission since a *prospective amendment, by its very definition, did not alter the existing law in respect of the past transactions.* [Honorable SC was not agree on this point - pls see-J(2)]

H. Contention of the assessee before Supreme Court

The basic submission of the Department to the effect that the amount received by the assessee as "dividend", in fact and in law, constitutes "return of investment" is fallacious for several reasons-

1) the question whether an amount is a "cost return" depends on the terms of the contract
2) If the argument of the Department is to be accepted that the amount represents "return of investment" then it would constitute a capital receipt and not a revenue receipt.
3) if the dividend of Rs. 4 per unit is treated as "expenditure" covered by Section 14A and not as "dividend" as required by Section 94(7), it would mean that for the assessment years 2000-01 and 2001-02 the assessee would be in a worse position because for the relevant assessment years based on the "fiscality principle" the entire loss of Rs. 1,85,68,015 would be disallowed whereas for the subsequent years after insertion of Section 94(7) w.e.f. 1.4.2002[applicable from assessment year 2002-03] only loss to the extent of the "dividend" amounting to Rs. 1,82,12,862 would stand disallowed leaving Rs. 3,55,153/- as loss allowable
4) That was never the intention of the Parliament for inserting Section 94(7). The said sub- section was not intended to be beneficial.
5) The fact that Section 94(7) allows loss in excess of dividend means that it accepts that the transaction is genuine and in course of business. If the transaction was a nullity, the entire loss would have been disallowed and not only to the extent of the dividend. Moreover, if losses could be disallowed on fiscality/ first principles then Section 94(7) is redundant.
6) Section 14A is enacted for non-deduction of expenditure whereas Section 94(7) is enacted to curb creation of short-term losses.
7) Fall or increase in NAV depended upon the value of the underlying assets and not on the basis of the dividend payout.

I. After hearing the both sides Supreme Court forms the following question of law

(i) Whether "return of investment" or "cost recovery" would fall within the expression "expenditure incurred" in Section 14A?

(ii) Impact of Section 94(7) w.e.f. 1.4.2002 on the impugned transactions.

(iii) Reconciliation of Section 14A with Section 94(7) of the Act.

J. Analysis by honorable supreme court-principle emerging from this case

1 First Question of law –

I.) After introduction of Section 14A the *permissible deductions enumerated in Sections 15 to 59*(thus cost of dividend as stated by Revenue in its SLP point no-2 is not covered by Section 14A) are to be allowed only with reference to income which is brought under one of the heads of income and is chargeable to tax. If an income like dividend income is not a part of the total income, the expenditure/ deduction though of the nature specified in Sections 15 to 59 but related to the income not forming part of total income could not be allowed against other income includible in the total income for the purpose of chargeability to tax.

II.) A pay- back in the strict sense does not constitute an "expenditure" as it does not impact the Profit & Loss Account. Pay-back or return of investment will impact the balance-sheet whereas return on investment will impact the Profit & Loss Account.

III.) Hence, expenditure, return on investment, return of investment and cost of acquisition are distinct concepts.

IV.) For attracting Section 14A, there has to be a proximate cause for disallowance, which is its relationship with the tax exempt income. Pay-back or return of investment is not such proximate cause, hence, Section 14A is not applicable in the present case. Thus, in the absence of such proximate cause for disallowance, Section 14A cannot be invoked. In our view, return of investment cannot be construed to mean "expenditure" and if it is construed to mean "expenditure" in the sense of physical spending still the expenditure was not such as could be claimed as an "allowance" against the profits of the relevant accounting year under Sections 30 to 37 of the Act and, therefore, Section 14A cannot be invoked.

V.) Hence, the two asset theory is not applicable in this case as there is no expenditure incurred in terms of Section 14A.

VI.) Honorable supreme court on the matter of applicability of Accounting standard 13 [as raised by Revenue in its first ground of SLP] provide that

1. That interest/ dividends received on investments are generally regarded as return on investment and not return of investment.
2. It is only in certain circumstances where the purchase price includes the right to receive crystallized and accrued dividends/ interest that have already accrued and become due for payment before the date of purchase of the units that the same has got to be reduced from the purchase cost of the investment.
3. A mere receipt of dividend subsequent to purchase of units, on the basis of a person holding units at the time of declaration of dividend on the record date, cannot go to offset the cost of acquisition of the units.
4. Therefore, AS-13 has no application to the facts of the present cases where units are bought at the ruling NAV with a right to receive dividend as and when declared in future and did not carry any vested right to claim dividends which had already accrued prior to the purchase

2. Second Question of law

If the argument of the Department is to be accepted, it would mean that before 1.4.2002 the entire loss would be disallowed as not genuine but, after 1.4.2002, a part of it would be allowable under Section 94(7) which cannot be the object of Section 94(7) which is inserted to curb tax avoidance by certain types of transactions in securities.

There is one more way of answering this point. Sections 14A and 94(7) were simultaneously inserted by the same Finance Act, 2001. As stated above, Section 14A was inserted w.e.f. 1.4.1962 whereas Section 94(7) was inserted w.e.f. 1.4.2002.

3. Third question of law

Section 14A deals with disallowance of expenditure incurred in earning tax-free income against the profits of the accounting year under Sections 30 to 37 of the Act. On the other hand, Section 94(7) refers to disallowance of the loss on the acquisition of an asset which situation is not there in cases falling under Section 14A.

Under Section 94(7) the dividend goes to reduce the loss it applies to cases where the loss is more than the dividend. Section 14A applies to cases where the assessee incurs expenditure to earn tax free income but where there is no acquisition of an asset.

Section 14A comes in when there is claim for deduction of an expenditure whereas Section 94(7) comes in when there is claim for allowance for the business loss.

JUDGMENT OF SUPREME COURT

All the three question of law answered by Supra court were against the Revenue and hence the impugned judgment of High court has been upheld.

Thanks

Amit kumar mishra
amit83india@gmail.com
9560310042