

Tax Hotline

August 02, 2005

RULING ON LEGALITY OF "DIVIDEND STRIPPING" TRANSACTIONS

The Income Tax Appellate Tribunal ("ITAT"), Mumbai, in a recent ruling in the case of Wallfort Shares & Stock Brokers Ltd. v. Income Tax Officer (for assessment years 2001-02 and 2000-01), held that mere knowledge of "dividend stripping" in a transaction does not render it to be a tax avoidance strategy, so long as the transactions between the parties take place at arm's length and the parties act in the ordinary course of their business. Further, the ITAT upheld the tax payer's right to set off losses from such transactions against income chargeable to tax.

In this case, the taxpayer company, (i.e., assessee), was a member of Mumbai Stock Exchange and traded in shares. The assessee claimed that it had incurred loss in the aforesaid transaction in the normal course of its business and, therefore, the loss should be treated as "business loss" and should be set off against income chargeable to tax.

The tax officer held that this transaction was a "dividend stripping" transaction wherein, shares were purchased cum - dividend, and after dividend was received, shares were sold ex-dividend. In the instant case, resultant loss was set off against other taxable income. The assessing officer further held that the assessee had entered into a pre-meditated arrangement with the mutual fund with the sole purpose of avoidance of tax and there was no commercial purpose whatsoever and hence, it cannot be treated as "business loss".

The assessee filed an appeal before the CIT (Appeals) who also held that the loss claimed by the assessee should be ignored as there was no commercial purpose involved in the transaction and the motive or intention of the assessee for entering into the transaction in question was tax avoidance. When the matter came up before the ITAT (Mumbai), the following three questions emanating from the dispute were considered - (a) Whether the transaction was a business transaction, (b) Whether the loss incurred by the assessee on purchase and sale of units of mutual fund is allowable, and (c) Whether the provisions of section 94(7) of the Income Tax Act, 1961 ("ITA"), can be interpreted as retrospective in operation and if so, its effect?

- With regard to the first issue, the ITAT observed that the parties to the transaction knew that this transaction in the units of the mutual fund scheme would serve as a tool for dividend stripping by interested parties. Nonetheless the transactions between the mutual fund and the assessee were at arm's length and none of these mutual funds acted in any manner different from what they were normally doing in the ordinary course of their business. The mere knowledge of the mutual fund that their units may be purchased and redeemed by dividend-strippers does not cloth the mutual fund as a party to tax avoidance.
- With regard to the second issue, the ITAT, referring to the case of Azadi Bachao Andolan ruled that it is not every device resorted to by a taxpayer to reduce his tax liability that can be disregarded irrespective of the legitimacy or genuineness of the act. Further, the ITAT emphasized that exemption under the provisions of section 10(33) of the ITA, to the income distributed by mutual funds has continued all these years and so long as the tax payers act in their ordinary course of business, not adopting any colorable devices, they are entitled to have the loss arising from such transactions set off against their income from any other transactions or source.
- With regard to the third issue, the ITAT held that the provisions of section 94(7) were introduced through the Finance Act, 2001, effective from April 1, 2002, which provide that the losses arising from the sale of securities or units (in respect of which dividend or income on such securities or units is exempt to tax) would be disallowed, if such securities or units have been purchased upto 3 months prior to the record date and have been sold within 3 months after such date. The ITAT referring to the CBDT Circular No.14 of 2001, held that this section cannot have a retrospective effect and prior to the assessment year 2002-03, it was legally permissible to claim the losses. Further, section 94(7) does not block "dividend strippers". It merely lays down a minimum holding period and is not against claiming of loss against the other income of the tax payer.

This ruling will give relief to several tax payers who were wrongfully denied losses arising from "dividend stripping" even prior to the year in which the provisions were amended to provide for a minimum holding period, under the guise of 'tax avoidance'.

Source: I.T.A.No.2307 (Mum) / 2004.

DISCLAIMER

The contents of this hotline should not be construed as legal opinion. View detailed disclaimer.

This Hotline provides general information existing at the time of preparation. The Hotline is intended as a news update and Nishith Desai Associates neither assumes nor accepts any responsibility for any loss arising to any person acting or

This is not a Spam mail. You have received this mail because you have either requested for it or someone must have suggested your name. Since India has no anti-spamming law, we refer to the US directive, which states that a mail cannot be considered Spam if it

Research Papers

Clinical Trials and Biomedical Research in India

April 22, 2025

Structuring Platform Investments in India For Foreign Investors

March 31, 2025

India's Oil & Gas Sector— at a Glance

March 27, 2025

Research Articles

2025 Watchlist: Life Sciences Sector India

April 04, 2025

Re-Evaluating Press Note 3 Of 2020: Should India's Land Borders Still Define Foreign Investment Boundaries?

February 04, 2025

INDIA 2025: The Emerging Powerhouse for Private Equity and M&A Deals

January 15, 2025

Audio

CCI's Deal Value Test

February 22, 2025

Securities Market Regulator's Continued Quest Against "Unfiltered" Financial Advice

December 18, 2024

Digital Lending - Part 1 - What's New with NBFC P2Ps

November 19, 2024

NDA Connect

Connect with us at events, conferences and seminars.

NDA Hotline

Click here to view Hotline archives.

Video

Vyapak Desai speaking on the danger of deepfakes | Legally Speaking with Tarun Nangia |

refraining from acting as a result of any material contained in this Hotline. It is recommended that professional advice be taken based on the specific facts and circumstances. This Hotline does not substitute the need to refer to the original pronouncements.

contains the sender's contact information, which this mail does. In case this mail doesn't concern you, please unsubscribe from mailing list.

NewsX

April 01, 2025

Vaibhav Parikh, Partner, Nishith Desai Associate on Tech, M&A, and Ease of Doing Business

March 19, 2025

SIAC 2025 Rules: Key changes & Implications

February 18, 2025

