

## **Karnataka High Court rules on the deductibility of expenses incurred towards transfer of capital assets while computing capital gains under Section 48 of the Income-tax Act ('ITA')**

The Hon'ble Karnataka High Court in its recent ruling<sup>1</sup> has held that payments made by the Assessee as part of the conditions attached to the Share Purchase Agreement ('SPA') and which are not directly connected with transfer of shares by the Assessee shall not be allowed as a deduction while computing capital gains under Section 48 of the ITA.

The Hon'ble High Court in its aforesaid ruling has held that in order to claim deduction under Section 48 of the ITA, the expenditure has to be incurred wholly and exclusively in connection with transfer of the capital assets and allowability of the same for computation of gains will depend upon the facts and circumstances of the case.

### **Background**

The Assessee, an individual held shares in a closely held company ('Company'). The Assessee along with other shareholders transferred their holdings in the Company to an entity in Mauritius for an agreed consideration.

As per the terms of the SPA entered between the Buyer and the Shareholders of the Company (including the Assessee), it was agreed that as a 'Condition Subsequent', the Shareholders shall pay an agreed amount to the Trust set up by the shareholders of the Company for the benefit of employees (including certain ex-employees) of the Company.

While computing the capital gains tax liability arising on transfer of shares, the Assessee claimed deduction in respect of the amount contributed towards the Trust.

The said deduction was claimed on the pretext that the contribution made by the Company towards the Trust, as part of the closing conditions, represents an amount incurred towards transfer of shares and thus should be allowed as a deduction while computing capital gains under Section 48 of the ITA.

The Assessing Officer ('AO') during the course of assessment proceedings and basis facts of the case, rejected the aforesaid contention of the Assessee and accordingly, disallowed the deduction claimed in respect of such payments. Aggrieved by the order of the AO, the Assessee contested the matter before the Commissioner of Income-tax Appeals ('CIT(A)') wherein the order of the AO was upheld.

The order of the CIT (A) was further contested by the Assessee before the Hon'ble Income-tax Appellate Tribunal ('ITAT') which upheld the observations of the AO and the CIT (A).

<sup>1</sup> Srinivasan Chandira Kumar Vs Additional Commissioner of Income-tax, Range -7(2) Bangalore, (2020) 121 taxmann.com 306 (Kar)

Basis specific facts of the case and terms of the SPA, the Hon'ble ITAT held that payments made by the Assessee towards the Trust can at best be considered as 'Voluntary Payments' by the Shareholders (including the Assessee) for ensuring the benefit of the existing employees of the Company and cannot be considered as expenses incurred for the purpose of transfer of shares.

Accordingly, such expenses cannot be allowed as a deduction for the purpose of computing capital gains under Section 48 of the ITA.

Aggrieved by the order of the Hon'ble ITAT, the Assessee filed an appeal before the Hon'ble High Court who held as under:

## What the Hon'ble High Court held

- Basis reading of the relevant clauses of the SPA, the contribution made by the Assessee towards the Trust cannot be treated as an expenditure incurred for transfer of shares.
- The contribution towards the Trust was made as part of the conditions of the SPA which were agreed between the Buyer and the Sellers and which had no bearing on the ability of the Assessee to transfer such shares to the Buyer.
- Thus, the payment made by the Assessee had no direct tax nexus with the event of the transfer of shares by the Assessee to the Buyer.
- Whether a particular expenditure can be considered as an amount incurred in connection with transfer of the 'capital assets' has to be determined in specific facts and circumstances of the case.
- Considering the above, deduction claimed by the Assessee towards its contribution towards the trust cannot be allowed as a deduction while computing capital gains.

## RBSA Take

The Ruling of the Hon'ble Karnataka High Court has made an important observation that whether a particular amount will qualify as 'an amount incurred towards transfer of capital assets' is a matter of fact and will require evaluation on a case to case basis.

However, the Ruling is silent on the aspects which the Transferor should examine while examining the eligibility of payments (i.e. made as part of the process of transfer of capital assets) as allowable deductions for the purpose of computing capital gains tax under Section 48 of the ITA.

As a result of the above ruling, one will have to be cautious before claiming deduction in respect of amounts which are incurred for consummation of the transfer of capital assets and which do not have a direct nexus with such transfer though they may be important for the closure of the transaction.

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