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by Shefali Goradia and Roshni Shankar

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India's Income Tax Appellate Tribunal (ITAT) in Mumbai, in *Wallfort Shares & Stock Brokers Ltd. v. Income Tax Officer*, held July 15 that mere knowledge of dividend stripping in a transaction does not render it a tax avoidance strategy if the transaction takes place at arm's length and the parties act in the ordinary course of business. In its decision, which concerned the 2000-2001 and 2001-2002 assessment years, the ITAT also upheld the taxpayer's right to set off losses from those transactions against income chargeable to tax.

The taxpayer (assessee) in the case was a member of the Mumbai Stock Exchange and traded in shares. The assessee claimed that it had incurred a loss in trading in the normal course of its business and that the loss should be treated as a business loss and set off against income chargeable to tax.

However, the tax officer ruled that the transaction was a dividend stripping transaction wherein shares were purchased cum dividend and, after the dividend was received, were sold ex dividend. The resultant loss was set off against other taxable income. The assessing officer also held that the assessee had entered into a premeditated arrangement with the mutual fund with the sole purpose of tax avoidance and with no commercial purpose and that the loss could not therefore be treated as a business loss.

The assessee filed an appeal before the commissioner of income tax (appeals), who also held that the loss should be ignored because the transaction involved no commercial purpose and that the assessee's motive or intention in entering into the transaction was tax avoidance.

The ITAT considered three questions: whether the transaction was a business transaction; whether the loss incurred by the assessee on purchase and sale of units of mutual funds was allowable; and whether the provisions of section 94(7) of the Income Tax Act, 1961 can be interpreted as being retrospective in operation and, if so, what effect they had.

Regarding the first issue, the ITAT observed that the parties to the transaction knew that the transaction in the units of the mutual fund scheme would serve as a tool for dividend stripping by interested parties. However, the transactions between the mutual fund and the assessee were at arm's length and none of the mutual funds acted differently than they would in the ordinary course of their business. The mere knowledge that their units could be purchased and redeemed by dividend strippers did not make the mutual fund a party to tax avoidance.

On the second issue, the ITAT referred to *Union of India vs. Azadi Bachao Andolan* (263 ITR 706) and held that not every device a taxpayer uses to reduce tax liability can be disregarded irrespective of the legitimacy or genuineness of the act. The ITAT emphasized that exemption under the provisions of section 10(33) of the ITA to the income distributed by mutual funds has continued for years, and so long as taxpayers act in their ordinary course of business, not adopting any colorable devices, they may have the loss arising from those transactions set off against their income from any other transactions or source.

Regarding the third issue, the ITAT held that the provisions of section 94(7) were introduced through the Finance Act, 2001, effective April 1, 2002, to provide that the losses arising from the sale of securities or units (regarding which dividend or income on the securities or units is exempt from tax) would be disallowed if the securities or units had been purchased up to three months before the record date and sold within three months after that date. Referring to the Central Board of Direct Taxes Circular No. 14 of 2001, the ITAT held that the provision cannot have a retrospective effect and that before the 2002-2003 assessment year, it was legally permissible to claim the losses. Further, section 94(7) does not block dividend strippers. Rather, it prescribes a minimum holding period and does not prohibit loss claims against the other income of the taxpayer.

The decision will give relief to several taxpayers who were wrongfully denied losses arising from dividend stripping that was deemed tax avoidance even before the year in which the provisions were amended to provide for a minimum holding period.◆

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