INCOME-TAX IMPLICATIONS OF CAPITAL REDUCTION — TRANSFER, CAPITAL ASSET, COMPUTATION, AND SECTION 50CA

Binoy Parikh *Joshita Chopra*

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Overview

This article examines the income-tax treatment of capital reduction under the Income-tax Act, 1961, tracing the jurisprudential evolution across four interconnected questions: whether capital reduction constitutes a "transfer" under Section 2(47), what the relevant capital asset is, how gains and losses are computed, and whether the anti-avoidance provision in Section 50CA applies.

Beginning with the Supreme Court's foundational ruling in Kartikeya Sarabhai *and moving through the Special Bench divergence in* Bennett Coleman, *the analysis tracks the judicial trajectory towards the present position as settled by the Supreme Court's observations in* Jupiter Capital *and the Mumbai ITAT's reasoning in* Carestream Health *and* Tata Sons. *The article establishes that the individual share, not the proportionate shareholding interest, is the unit of analysis for Section 2(47), that cancellation of shares constitutes a transfer even where no consideration is paid, and that capital loss is allowable in zero-payout reductions where the computation mechanism under Section 48 remains operable.*

The final sections address the interaction of Section 50CA with both payout and zero-payout reductions, the residual uncertainty around face value reductions without consideration, and the expanding commercial deployment of capital reduction across squeeze-outs, surplus distributions, and restructurings.

I. Introduction

Alteration of share capital by way of cancellation and extinguishment of shares, or reduction in face value, can be carried out by undertaking capital reduction under Section 66 or a scheme of arrangement under Section 230 of the Companies Act, 2013. The central income-tax question arising from such a reduction is whether it constitutes a "transfer" within Section 2(47) of the

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Income-tax Act, 1961 ("the 1961 Act"), and if so, how the resulting gain or loss should be computed. This article analyses each of these limbs: first, whether and when capital reduction constitutes a "transfer"; second, the identification of the capital asset; third, the computation of gains and losses across different fact patterns; and finally, the applicability of the anti-avoidance provision in Section 50CA.

II. Statutory Framework

The chargeability of capital gains under Section 45 of the 1961 Act[1] requires three elements: the existence of a capital asset, a "transfer" of that asset, and the profits or gains (including losses) arising from such transfer. "Capital asset" is defined in Section 2(14) to include property of any kind held by an assessee[2]. Shares held by a shareholder are capital assets within this definition. "Transfer" is defined in Section 2(47) to cover, *inter alia*, the sale, exchange, or relinquishment of a capital asset, the extinguishment of any rights therein, and compulsory acquisition[3]. The computation mechanism under Section 48[4] yields the capital gain or loss as the difference between the full value of consideration received or accruing on the transfer, and the cost of acquisition and improvement of the asset. No provision of Section 47[5] exempts capital reduction from the charge of capital gains, unlike amalgamation, demerger, or conversion of bonds into shares.

Each of these elements raises distinct questions in the context of capital reduction, and several case laws have developed along each limb independently.

III. Capital Reduction as a "Transfer" Under Section 2(47)

A. Reduction of Face Value

In ***Kartikeya V. Sarabhai v. CIT***[6], the Supreme Court held that reduction of the face value of preference shares from ₹ 1,000 to ₹ 50, against payment of ₹ 950 per share, constituted a "transfer" within Section 2(47). The Court reasoned that when face value is reduced, the shareholder's right to dividends on the full capital and the right to participate in net assets upon liquidation is also proportionately reduced. This extinguishment falls within the statutory definition of transfer. The Court clarified that a sale in the conventional sense is not required; relinquishment or extinguishment of rights in a capital asset is independently sufficient.

CIT v. Grace Collis[7] reinforced this position in the context of amalgamation, holding that the extinguishment of a shareholder's rights in the transferor company constitutes a "transfer" within Section 2(47). While the case concerned amalgamation, the principle that extinguishment of rights is a species of "transfer" applies with equal force to capital reduction and has been relied upon in subsequent capital reduction decisions.

1. *Section 45, Income-tax Act, 1961; Section 67, Income-tax Act, 2025.*
2. *Section 2(14), Income-tax Act, 1961; Section 2(22), Income-tax Act, 2025.*
3. *Section 2(47)(i) to (vi), Income-tax Act, 1961. The 2025 Act carries forward substantially the same inclusive definition in Section 2(109).*
4. *Section 48, Income-tax Act, 1961; Section 72, Income-tax Act, 2025.*
5. *Section 47, Income-tax Act, 1961; Section 70, Income-tax Act, 2025.*
6. *Kartikeya V. Sarabhai v. CIT [1997] 228 ITR 163 (SC).*
7. *CIT v. Grace Collis [2001] 248 ITR 323 (SC).*

The Special Bench of the Mumbai ITAT in ***Bennett Coleman & Co. Ltd. v. ACIT***[8] departed from this position. The face value of shares in Times Guarantee Ltd. was halved from ₹ 10 to ₹ 5, and two shares of ₹ 5 each were thereafter consolidated into one share of ₹ 10, without any consideration. The Special Bench held that this did not constitute a "transfer", on two grounds. First, the assessee's proportionate shareholding, voting power, and share of net assets remained identical before and after the reduction, so there was no real extinguishment of rights. Second, since no consideration was received or receivable, the computation mechanism under Section 48 failed. It followed the B.C. Srinivasa Setty Supreme Court ruling[9], which held that if the computation provision cannot be applied and fails, capital gains cannot be assessed under Section 45.

Bennett Coleman thus introduced two propositions that ran counter to *Kartikeya Sarabhai*: proportionate shareholding, rather than the number or face value of shares held, is the relevant measure of whether rights have been extinguished; and that the absence of consideration renders the computation machinery inoperable, removing the transaction from the charge of capital gains altogether. Both propositions would be tested, and ultimately rejected, in the decisions that followed regarding cancellation of shares.

B. Cancellation of Shares

The Bangalore ITAT in ***Jupiter Capital Pvt. Ltd. v. ACIT***[10] held that cancellation of shares on capital reduction amounts to extinguishment of rights within Section 2(47). Jupiter Capital held 99.88% of ANNPL. Under a court-sanctioned reduction, Jupiter Capital's holding was reduced from 15.33 crore shares to 9,988 shares, with a consideration of approximately ₹ 3.18 crore. The Assessing Officer had disallowed the capital loss claim on the ground that proportionate shareholding was unchanged.

The Karnataka High Court upheld the ITAT and allowed the capital loss. The Supreme Court dismissed the Revenue's Special Leave Petition[11], observing that the reduction in share capital and subsequent proportionate reduction in the shareholding of the assessee is covered within the ambit of Section 2(47). In doing so, the Court reaffirmed *Kartikeya Sarabhai* and endorsed the Gujarat High Court's observation in ***CIT v. Jaykrishna Harivallabhdas***[12], that receipt of consideration is not a precondition for computation of capital gains on extinguishment of rights. The Supreme Court's observations while dismissing the petition carry significant persuasive force and, practically, settle the question for share cancellation scenarios.

IV. The Share as the Unit of Analysis

The Revenue's argument, running through from Bennett Coleman to Jupiter Capital, consistently relied on the proposition that if the shareholder's proportionate interest in the company is unchanged, no transfer has occurred. The Mumbai ITAT's decision in ***Carestream Health Inc. v. DCIT***[13] addressed

8. *Bennett Coleman & Co. Ltd. v. ACIT [2011] 12 ITR(T) 97 (Mumbai) (Special Bench).*
9. *CIT v. B.C. Srinivasa Setty [1981] 128 ITR 294 (SC). The principle is that where the computation provisions of Section 48 cannot be applied, the charge under Section 45 does not arise.*
10. *Jupiter Capital Pvt. Ltd. v. ACIT, ITA No. 445/Bang/2018 (ITAT Bangalore, order dated November 29, 2018).*
11. *PCIT v. Jupiter Capital Pvt. Ltd. [2025] 170 taxmann.com 305 (SC), SLP No. 63 of 2025, order dated January 2, 2025.*
12. *CIT v. Jaykrishna Harivallabhdas [1998] 231 ITR 108 (Gujarat HC).*
13. *Carestream Health Inc. v. DCIT, ITA No. 826/Mum/2016 (Mumbai ITAT).*

a foundational question that cuts across both the transfer and computation enquiries: what is the relevant capital asset?

The Indian wholly-owned subsidiary of Carestream Health, a US tax resident, halved its share capital by way of capital reduction; however, Carestream Health continued to hold 100% of its share capital after the capital reduction. The Tribunal rejected the proportionate-interest test. It held that the capital asset for the purposes of Section 2(47) is the "share" itself, not the "percentage of shareholding". Each share is an independent capital asset and the cancellation of each share is an independent extinguishment event. The percentage of shareholding is a derivative measure that reflects the ratio between the shareholder's holding and the company's total issued capital; it is not the asset itself. This ruling has significant implications. It means that even where a proportionate reduction leaves the shareholder's percentage unchanged (as in Bennett Coleman and Carestream Health itself), the cancellation of individual shares constitutes a transfer of capital assets. The unit-of-analysis question is therefore resolved in favour of the individual share.

V. Computation of Capital Gains and Losses

A. Bifurcation: Deemed Dividend and Capital Gains

Where consideration is received on capital reduction, the first computational step is the bifurcation established by the Supreme Court in ***CIT v. G. Narasimhan***[14]. The Court held that to the extent the distribution is represented by accumulated profits, it constitutes deemed dividend under Section 2(22)(d)[15]; the balance, being a return of capital, is chargeable under the head "Capital Gains". The capital gain or loss under Section 48 is then computed as the full value of consideration (after carving out the deemed dividend component) less the cost of acquisition.

In partial capital reductions where only some shares are cancelled, cost apportionment becomes relevant. The 1961 Act does not contain a specific provision for this. The logical approach is per-share apportionment: if a shareholder holds 1,000 shares at a cost of ₹ 100 each and 500 shares are cancelled for a consideration of ₹ 30 per share, the capital loss on the cancelled tranche is ₹ 70 per share, aggregating to ₹ 35,000. The surviving 500 shares retain their original cost of ₹ 100 each.

B. The Zero-Payout Problem

The Mumbai ITAT in ***Tata Sons Ltd. v. PCIT***[16] addressed capital reduction without any consideration. Tata Sons held shares in TTSL, which had incurred substantial losses. Under a court-sanctioned scheme, TTSL cancelled half of the issued share capital, with the resulting amount written off against accumulated losses and share premium. No payout was made to Tata Sons against cancellation of its shareholding. The PCIT invoked revisionary jurisdiction under Section 263 to disallow the capital loss, relying on Bennett Coleman.

The Tribunal distinguished Bennett Coleman and held that: reduction of capital by cancellation of shares constitutes

14. *CIT v. G. Narasimhan [1999] 236 ITR 327 (SC).*
15. *Section 2(22)(d), Income-tax Act, 1961; Section 2(40)(d), Income-tax Act, 2025.*
16. *Tata Sons Ltd. v. PCIT [2024] 158 taxmann.com 601 (Mumbai ITAT), order dated January 23, 2024.*

Reduction of capital by cancellation of shares constitutes extinguishment of rights and therefore is a "transfer"; the resulting loss is a real capital loss, not a notional one, because the shareholder's investment has been genuinely eroded.

extinguishment of rights and therefore is a "transfer"; the resulting loss is a real capital loss, not a notional one, because the shareholder's investment has been genuinely eroded; and the principle in B.C. Srinivasa Setty has no application where the cost of acquisition and the full value of consideration are both conceivable and ascertainable, even if the latter is nil.

C. Ascertainability of Consideration

The distinction drawn by the Tribunal, in the Tata Sons case, between two categories of scenarios is analytically significant. In the first category, consideration is inherently unascertainable, as with self-generated goodwill, the subject matter of B.C. Srinivasa Setty. Here the computation mechanism genuinely fails because there is no conceivable cost of acquisition, and the charge under Section 45 cannot arise. In the second category, consideration is ascertainable but happens to be NIL. Both, the full value of consideration and the cost of acquisition, are known quantities, and the computation under Section 48 proceeds normally to yield a capital loss equal to the cost of acquisition.

The Gujarat High Court's decision in Jaykrishna Harivallabhdas had reached this conclusion earlier in the context of liquidation, allowing a capital loss under Section 46(2) read with Section 48 where no payout was received. The Supreme Court's endorsement of this decision in Jupiter Capital reinforces the position at the appellate level. The combined effect is that a shareholder whose shares are cancelled in a zero-payout capital reduction is entitled to claim a capital loss equal to the cost of acquisition of the cancelled shares.

VI. Applicability of Section 50CA

Section 50CA of the 1961 Act, inserted by the Finance Act, 2017 with effect from Assessment Year 2018-19, provides that where the consideration received or accruing as a result of the transfer of an unquoted share is less than its fair market value ("FMV"), the FMV shall be deemed to be the full value of consideration for the purposes of Section 48[17]. The provision is an anti-avoidance measure directed at the undervaluation of shares in private company transfers. Its application to capital reduction transactions raises several questions.

A. Capital Reduction With a Payout

Where capital reduction involves payment of consideration and the cancelled shares are unquoted, Section 50CA appears to apply on a plain reading. If the consideration paid is less than the FMV determined under Rule 11UAA (i.e., adjusted net book value for equity shares, and actual FMV for other

Where capital reduction involves payment of consideration and the cancelled shares are unquoted, Section 50CA appears to apply on a plain reading.

17. *Section 50CA, Income-tax Act, 1961; Section 79, Income-tax Act, 2025. The FMV is determined under Rule 11UAA of the Income-tax Rules, 1962.*

shares such as RPS/CCPS/OCRPS), the FMV is deemed the full value of consideration. However, this creates a difficulty where the payout is partly characterised as deemed dividend under Section 2(22)(d). The deemed consideration under Section 50CA would be the entire FMV, while the accumulated profits component has already been carved out as deemed dividend. This produces a risk of double taxation to the extent the FMV reflects accumulated profits embedded in net worth. The better view is that Section 50CA should operate only on the capital gains component, since the deemed dividend portion is not income under the head "Capital Gains" and Section 50CA operates exclusively within the computation machinery of Section 48. This interpretation awaits judicial or legislative clarification.

B. Capital Reduction Without a Payout

Where no consideration is paid, a strong argument exists that Section 50CA should not apply. The section is triggered where the "consideration received or accruing as a result of the transfer" is less than FMV. "Less than" is a comparative expression requiring a base value. Where there is no consideration at all, the comparative mechanism has nothing to operate on. This is not a case of consideration being less than FMV; it is a case of there being no consideration "received or accrued", and without the consideration variable, the trigger fails.

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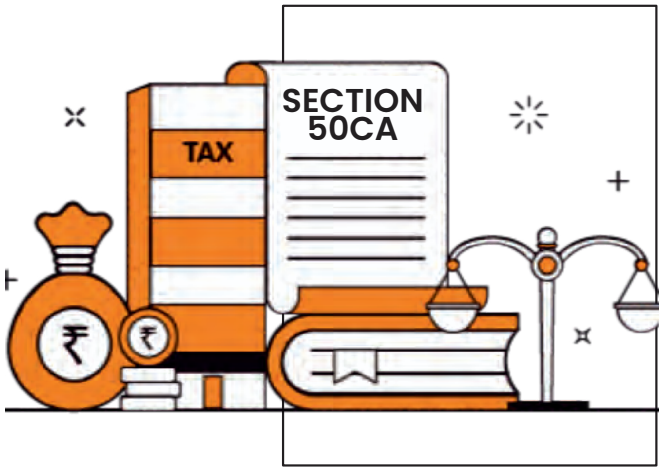

A further structural argument reinforces this position. Section 50CA was designed for bilateral share transfers where there is a willing buyer and willing seller, and the consideration is being suppressed below FMV to avoid tax. Capital reduction is a NCLT-sanctioned corporate act, not a negotiated transfer between two parties. The mischief that Section 50CA targets, namely undervaluation in private transfers, does not arise in court-sanctioned reductions where the terms are judicially scrutinised. Moreover, Section 50CA is a deeming fiction, and deeming fictions are to be construed strictly. The "transfer" within Section 50CA need not carry the same expansive meaning as "transfer" within Section 2(47), particularly given that the former operates as a penal substitution mechanism while the latter is a definitional provision.

C. Face Value Reduction

In cases of face value reduction (as opposed to share cancellation), Section 50CA may not apply for an additional reason. The section speaks of the transfer of a "share" and the FMV determined under Rule 11UAA is the FMV of one share. When rights in a share

are partially extinguished through face value reduction, there is no transfer of a complete share, and the FMV substitution mechanism may not operate. This question remains untested in reported decisions.

VII. Residual Issues

A. The Status of Bennett Coleman

The Supreme Court's observations in Jupiter Capital settle the law for share cancellation scenarios, considering it as a "transfer". The Carestream Health ruling established that each individual share is a capital asset, and not the proportionate shareholding interest. The Tata Sons decision reinforces this at the Tribunal level, even where there is no payment of consideration against a reduction. However, the specific fact pattern of Bennett Coleman, being face value reduction followed by consolidation without any consideration, has not been directly addressed by the Supreme Court. While Kartikeya Sarabhai also involved a face value reduction, the Bennett Coleman Special Bench distinguished it on the ground that Kartikeya Sarabhai involved payment of consideration. A residual uncertainty, therefore, persists in the narrow configuration of face value reduction without payout.

B. Set-off and Carry Forward

Capital loss arising from capital reduction is governed by the general provisions of Sections 70, 71, and 74 of the 1961 Act[18]. Long-term capital loss can be set off only against long-term capital gains and carried forward for eight assessment years. In group restructurings where a holding company incurs capital loss on capital reduction of a subsidiary, the availability of long-term capital gains within the carry-forward window is a relevant structuring consideration.

C. The Broader Commercial Context

Capital reduction is no longer merely a tool for writing off accumulated losses. It has evolved into a versatile restructuring mechanism deployed across a range of corporate objectives: minority squeeze-outs (as in the Bharti Telecom transaction, where a selective capital reduction was deployed to consolidate ownership by extinguishing minority shareholdings at a determined price per share), surplus distribution as an alternative to buyback, balance sheet rehabilitation in distressed situations, and clean exits for private equity investors and joint venture partners through selective reduction of a specific class or series of shares. Each of these applications engages the tax framework analysed in this article: particularly the G. Narasimhan bifurcation, the Tata Sons zero-payout analysis, and the Section 50CA questions.

The tax framework as it now stands accommodates each of these commercial applications. The recognition of capital reduction as a "transfer", the identification of the individual share as the unit of analysis, the allowability of capital loss even in zero-payout scenarios, and the bifurcation of proceeds into deemed dividend and capital gains provide a workable, albeit incomplete, architecture. The unresolved questions around Section 50CA and face value reductions are the remaining friction points, and they are likely to be tested as the commercial use of capital reduction continues to expand.

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18. Sections 70, 71, and 74, Income-tax Act, 1961; corresponding to Sections 108, 109, and 111 of the Income-tax Act, 2025.