



Tax Flash News



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Genuine commercial transactions through recognised stock exchanges do not warrant GAAR absent evidence of tax avoidance

Executive summary



In the case of *EKGE Retail LLP*,¹ the Telangana High Court held that the General Anti-Avoidance Rule ('GAAR') could not be invoked merely because short-term capital losses arising from transactions in listed shares undertaken around a bonus issue were set off against long-term capital gains from the slump sale of a business. The Revenue had failed to establish that the transactions constituted an "arrangement" or that their main purpose was to obtain a tax benefit.

The Court noted that the taxpayer had purchased and sold listed shares through recognised stock exchanges at prevailing market prices, in a transparent manner, at arm's-length. The gains or losses depended on market movements and were not predetermined.

The Court further held that the Revenue had not established misuse or abuse of the Act, or that the transactions were conducted through means or in a manner not ordinarily employed for *bona fide* purposes. Accordingly, it set aside the approving panel's directions treating the transactions as an impermissible avoidance arrangement ('IAA') and allowed the taxpayer's writ petition.

¹ *Ekge Retail LLP v. ACIT* (Writ Petition No. 21210 of 2022)

Facts of the case



The taxpayer had an investable surplus and decided to diversify its investments.

It purchased shares of listed companies which subsequently issued bonus shares.

The taxpayer thereafter sold a portion of its shareholdings, resulting in short-term capital losses.

During the same financial year, the taxpayer earned long-term capital gains from the slump sale of its business. It set off the short-term capital losses against these gains.

The Revenue alleged that the share transactions were undertaken to generate capital losses for set-off against capital gains. It invoked GAAR provisions and referred the matter to the approving panel.

The approving panel treated the transactions as an IAA. The taxpayer challenged this order before the Telangana High Court by way of writ petition.

Relevant provisions



GAAR provisions are applicable if an arrangement qualifies as an IAA.

Section 96(1) of the Income-tax Act, 1961 ('the 1961 Act') provides that an arrangement is an IAA where its main purpose is to obtain a tax benefit and it also satisfies at least one of the specified conditions, including misuse or abuse of the 1961 Act or being entered into or carried out by means or in a manner not ordinarily employed for *bona fide* purposes.

Section 102(1) defines an "arrangement" to include any step in, or part or whole of, a transaction, operation, scheme, agreement or understanding, whether enforceable or not.

Revenue's contentions



The taxpayer had structured its transactions so that the provisions governing the cost of bonus shares, under which their cost of acquisition was taken as nil, and the FIFO method prescribed by CBDT Circular,² operated together to generate short-term capital losses. This established the requisite purpose of obtaining a tax benefit.

² CBDT Circular No. 704 dated 28 April 1995

The transactions were not undertaken for *bona fide* commercial purposes and were designed to obtain a tax benefit by setting off short-term capital losses against long-term capital gains.

High Court's decision



The Court set aside the approving panel's directions and held that the taxpayer was entitled to set off the short-term capital losses against the long-term capital gains arising from the slump sale.

The Revenue had failed to establish that the transactions constituted an arrangement, that their main purpose was to obtain a tax benefit, or that they involved misuse or abuse of the 1961 Act or were carried out through means or in a manner not ordinarily employed for *bona fide* purposes.

Transactions did not constitute an “arrangement”

GAAR carries serious consequences and its statutory conditions must be construed strictly. Before GAAR can be invoked, the Revenue must establish the existence of an arrangement, the requisite main purpose of obtaining a tax benefit and at least one of the specified conditions.

The expressions used in the definition of an “arrangement” imply a degree of concert or design between identifiable parties or, at the very least, a pre-ordained series of steps whose outcome is within the taxpayer's control.

In this case, the taxpayer purchased and sold shares of listed companies through recognised stock exchanges at prevailing open-market prices. The transactions were conducted at arm's length and transparently, and the counterparties could not be identified by the taxpayer. The gains or losses depended on market movements beyond its control and were not predetermined. Accordingly, the transactions could not be characterised as an arrangement within the meaning of the 1961 Act.

Tax benefit must be the main purpose

Even if the transactions were assumed to constitute an arrangement, the Revenue had to establish that obtaining a tax benefit was the main purpose, not merely an incidental consequence. The fact that the taxpayer subsequently claimed a set-off expressly permitted by the Act could not, by itself, establish that the transactions had been undertaken mainly to obtain a tax benefit.

Transactions were conducted through ordinary means for bona fide purposes

The relevant test concerned the means and manner in which the transactions were conducted, rather than their outcome. Purchases and sales of listed securities through recognised stock exchanges regulated by the Securities and Exchange Board of India, with Securities Transaction Tax and applicable service tax duly paid, represented ordinary, conventional and bona fide methods of dealing in securities.

The search and seizure operation conducted at the taxpayer's premises yielded no incriminating material.

Accordingly, the condition concerning transactions conducted through means or in a manner not ordinarily employed for *bona fide* purposes was not satisfied.

Commercial rationale for investment decisions

The taxpayer had received an investable surplus of following the sale of its business. It consulted leading financial institutions and an internal consultant to advise on the deployment of the funds.

The taxpayer allocated one-third of the funds to listed equities and two-thirds to bonds and debt mutual funds. The purchase of pre-bonus shares formed part of this equity allocation and was based on advice that historical market trends offered the possibility of short-term arbitrage returns of 1 per cent to 3 per cent.

The taxpayer sold only a portion of its pre-bonus shareholdings after the bonus allotment and continued to hold a substantial part of its investments. This was inconsistent with the allegation that its sole objective was to generate capital losses.

Set-off did not amount to misuse or abuse of the 1961 Act

The Revenue had wrongly inferred the taxpayer's intention from the resulting tax benefit, reasoning backwards from the outcome to the purpose. A taxpayer is entitled to arrange its affairs to minimise tax within the law. A lawful course of action does not become impermissible merely because it is tax-efficient.

The Court considered this to be the application of statutory provisions for computing total income, rather than a tax benefit obtained by circumventing or subverting the 1961 Act, which must involve more than the direct application of a computation provision to a genuine, commercially incurred loss.

The taxpayer had computed the cost of bonus shares in accordance with the applicable statutory provisions, followed the FIFO method prescribed by the CBDT Circular and computed the slump-sale gains under the applicable provisions. As the set-off provision had been used for its intended purpose, there was no misuse or abuse of the 1961 Act.

Our comments



The ruling emphasises that GAAR cannot be invoked solely because a transaction results in a tax advantage. The decision also highlights the distinction between a transaction's tax outcome and its commercial purpose. Where investments are made through recognised stock exchanges and losses are set off in accordance with the 1961 Act, the resulting tax efficiency does not automatically render the transactions impermissible. The Revenue must demonstrate that the statutory requirements for invoking GAAR are met.



KPMG in India addresses:

Ahmedabad

Commerce House V, 9th Floor, 902, Near Vodafone House, Corporate Road, Prahlad Nagar, Ahmedabad – 380 051.
Tel: +91 79 4040 2200

Bengaluru

Embassy Golf Links Business Park, Pebble Beach, 13/02, 'B' Block, 1st & 2nd Floor, Off Intermediate Ring Road, Bengaluru – 560 071
Tel: +91 80 6833 5000

Chandigarh

Elante Offices, Unit No. A505, 5th Floor, Plot No.178-178A, Industrial Area Phase-1, Chandigarh – 160 002.
Tel: +91 172 664 4000

Chennai

KRM Towers, Ground, 1st, 2nd, & 3rd Floor, No. 1, Harrington Road, Chetpet, Chennai – 600 031.
Tel: +91 44 3914 5000

Gurugram

Building No.10, 8th Floor, DLF Cyber City, Phase II, Gurugram, Haryana – 122 002.
Tel: +91 124 307 4000

Hyderabad

Salarpuria Knowledge City, Orwell 6th Floor, Unit-3, Survey No 83/1, Plot No 2, Raidurg, Hyderabad – 500 081.Tel: +91 40 6111 6000

Jaipur

Signature Towers, Office No. 402, Fourth Floor, S Plot No. DC-II, Lal Kothi District Shopping Center, Tonk Road, Jaipur – 302 001
Tel: +91 141 – 672 1000

Kochi

Syama Business Centre, 49/179, 3rd Floor, NH 47, Bypass Road, Vytilla, Kochi – 682 019.
Tel: +91 484 302 5600

Kolkata

Unit No. 604, 6th Floor, Tower – 1, Godrej Waterside, Sector – V, Salt Lake, Kolkata – 700 091.
Tel: +91 33 4403 4000

Mumbai

Lodha Excelus, Apollo Mills Compound, 2nd Floor, N M Joshi Marg, Lower Parel, Mumbai- 400 011.
Tel: +91 22 3989 6000

Noida

Unit No. 501, 5th Floor, Advant Navis Business Park, Tower-A, Plot# 7, Sector 142, Expressway Noida, Gautam Budh Nagar, Noida – 201 305.
Tel: +91 0120 386 8000

Pune

9th floor, Business Plaza, Westin Hotel Campus, 36/3-B, Koregaon Park Annex, Mundhwa Road, Ghorpadi, Pune – 411 001.
Tel: +91 20 6747 7000

Vadodara

Ocean Building, 303, 3rd Floor, Beside Center Square Mall, Opp. Vadodara Central Mall, Dr. Vikram Sarabhai Marg, Vadodara – 390 023.
Tel: +91 265 619 4200

Vijayawada

PR heights, 4th Floor, NH 16 Service Rd, opp. Manipal Hospital Road, Tadepalle, Andhra Pradesh – 522 501.
Tel: +91 0864 536 2000

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KPMG Assurance and Consulting Services LLP, Lodha Excelus, Apollo Mills Compound, NM Joshi Marg, Lower Parel, Mumbai - 400 011 Phone: +91 22 3989 6000, Fax: +91 22 3983 6000

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