Taxability of Capital Market transactions

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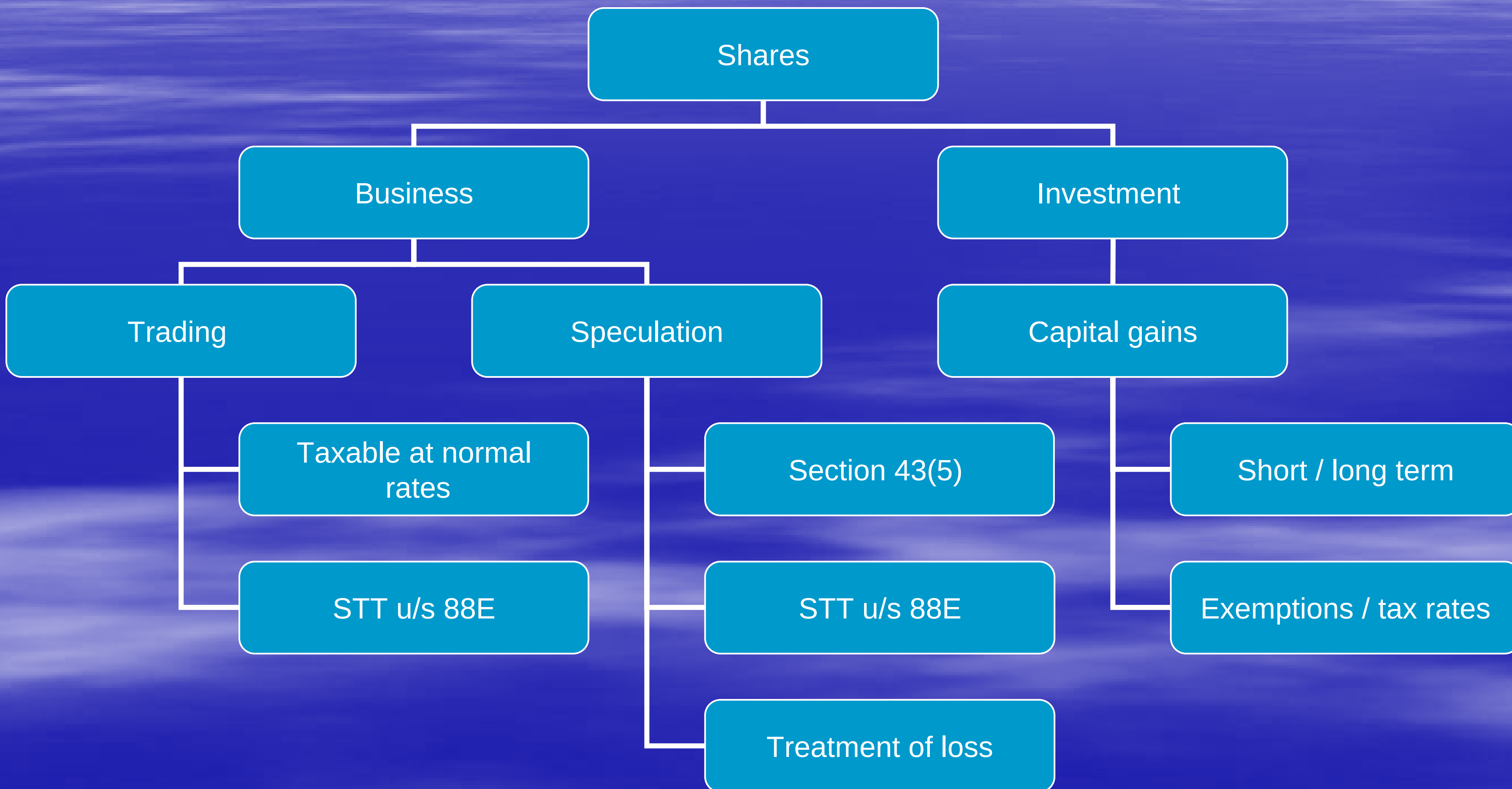
Income from capital market



Statutory provisions

- Business
- F&O
- STT
- Dividend
- Expenditure for earning dividend

Securities Transaction Tax

<u>Section 88E</u>

- *Income from taxable securities transactions* chargeable to tax under the head 'Profit & gains from business & profession'
- STT allowed as a deduction from *tax payable on such income*
- *Tax payable on such income* to be calculated by applying average rate of income tax on such income

Effect of Section 88E

- Scheme beneficial for assessees in higher tax bracket
- No deduction in case of loss or income below taxable limits
- Loss of STT paid:

Income from taxable securities	: Rs5.00 lacs
STT paid	: Rs3.00 lacs
Average rate of tax	: 25%
Rebate of STT restricted to	: Rs1.25 lacs

Speculative transaction

- What is a speculative transaction
- How it constitutes a separate business
- Taxability of gain
- Treatment of loss
- STT

Speculative transactions

- Section 43(5): "Speculative transaction" means a transaction in which a contract for purchase or sale of commodity, including stocks and shares, is periodically or ultimately settled otherwise than by the actual delivery or transfer of the commodity or scrips
- Unless the transaction settled by actual delivery or transfer, it will be a speculative transaction.

  Jute Investment Co. AIR 1980 SC 483
- Transaction speculative for the purpose of section 43(5) even if intention to take actual delivery could not be effectuated

  M.R. Dhawan v. CIT (1979) 119 ITR 412 (Delhi)

Speculative transactions

- Exceptions provided by the proviso:
  - A contract in respect of RM or merchandise to safe guard from loss due to future price fluctuations in respect of actual delivery
  - A contract in respect of stocks & shares entered into by a dealer or investor to guard against loss in holding of stocks & shares
  - A contract entered into by a member of a forward market or a stock exchange in the course of any transaction in the nature of jobbing or arbitrage to guard against loss in the ordinary course of his business

Speculative transactions

Proviso (d) inserted by F.Act, 2005 wef 1-4-2006

- Trading in derivatives not a speculative transaction:
  - Derivatives referred to in section 2(ac) of the Securities Contracts (Regulation) Act,1956
  - carried out in a recognised stock exchange
  - electronically on a screen based system
  - through a broker or a sub-broker registered u/s 12 of SEBI
  - supported by a time stamped contract note
  - containing client identity no. & PAN no.
- Treatment of unabsorbed brought forward loss from trading in derivatives?

Treatment of speculation loss

<u>Section 73</u>

- Loss from speculation business can be set off against profits & gains of another speculation business
- Unabsorbed loss can be carried forward for maximum upto 4 AY succeeding the year of loss

Speculation business

- Explanation 2 to Section 28: Where speculative transaction carried on by an assessee are of such a nature as to constitute a business, the business shall be deemed to be distinct and separate from any other business.
- Share broker carrying out self trading of the nature of speculative transactions?
- Manufacturing company carrying on trading of shares of other companies?

Speculation business

Explanation to section 73

- Business of a company consists of purchase & sale of shares of other companies:
  - For the purpose of set off and carry forward of loss
  - Deemed to be carrying speculation business to the extent of such business of purchase & sale of shares
- Exceptions :
  - Companies whose gross total income consists mainly of income chargeable under the head "Interest on securities", "Income from house property", "Capital gains" & "Income from other sources"
  - Companies carrying on banking business or granting of loans & advances

Explanation to section 73

<u>Implication</u>

- Applies only to companies
- Loss from trading in shares cannot be set off against income from other business & profession

Shares held as capital asset

- Period of holding
- Exemptions
- Rates of taxes
- Special provisions

Long term capital asset

- Held for more than 12 months in the case of:
  - Shares held in a company
  - Securities listed in a recognised stock exchange in India
  - Units of UTI
  - Units of a mutual fund specified u/s 10(23D)
  - Zero coupon bonds
- Period to be considered from date of allotment for:
  - Shares
  - Rights issue
  - Bonus shares
- For right to subscribe from the date of offer
- Date of broker's note in case acquired from stock exchange
- In case of several lots FIFO to be followed: Circular No. 704 dt 28-4-95

Equity shares

<u>Section 10 (36)</u>

- BSE 500 index
- Shares acquired between 1-3-2003 & 29-2-2004
- Transferred after 12 months through a recognised stock exchange
- Capital gains not chargeable to tax
- Exemption has become redundant after introduction of section 10 (38)

Equity shares

Section 10(38)

- Long term capital gains arising from:
  - Equity shares in a company
  - Units of an equity oriented fund
- Exempt from tax, provided transaction of sale is entered into after the date of application of chapter VII. (1-10-2004)
- STT has been paid on the said transaction
- Exemption available to all assessee
- Long term capital asset
- Similar conditions for short term capital assets for reduced rate of tax of 10% u/s 111A

Capital gains exempt from tax

- Capital gains not chargeable to tax by virtue of section 10 of the Act. In case assets are transferred at a loss?

CIT v. S.S. Thiagarjan 129 ITR 115 (Mad.)

Ramjilal Rais v. CIT 58 ITR 181 (All.)

Rate of tax on LTCG

Section 112

- Tax @ 20%
- Proviso for tax to be restricted to 10% without indexation benefit in case of listed securities, etc
- Unutilised exemption limit can be availed
- No deduction under Chapter VIA
- No rebate u/s 88
- Rebate u/s 88B & 88C are allowed from the tax

Tax on short term capital gains from shares, etc

Section 111A

- Tax @ 10% on short term capital gains of:
  - Equity shares
  - Units of an equity oriented funds
- Reduced rate only in case STT paid on the trf of such shares
- Unutilised basic exemption limit can be availed
- No deduction under Chapter VIA
- No rebate u/s 88
- Rebate u/s 88B & 88C are allowed from the tax

Cost of acquisition of shares

Section 55

- Cost of acquisition of shares:
  - Rights issue
  - Bonus shares
  - Rights renounced
  - Acquisition of right renounced and subscription to the rights issue

Special provisions

Section 94 (1),(2) & (3)

- Provisions to curb tax avoidance
  - Securities sold and then repurchased
  - Beneficial interest in securities transferred during the yr
- Applicable to business as well as capital assets
- Provisions not applicable, in case:
  - There is no avoidance of income tax or
  - That the avoidance was exceptional & not systematic with no such avoidance in the previous 3 yrs

Loss in dividend stripping transactions

Section 94 (7)

- Securities/ units acquired within 3 months prior to the record date
- Such securities sold with in 3 months after such date or
- Units sold with in 9 months after such date
- Dividend or income received is exempt
- Loss arising from the transaction to the extent of dividend to be ignored
- Term “securities” to include stocks & shares

Loss / bonus shares

<u>Section 94 (8)</u>

- Units acquired with in 3 months prior to the record date
- Bonus/ additional units allotted without any payment
- Original units sold with in a period of 9 months without bonus/ additional units
- Loss to be ignored for the purpose of computing income chargeable to tax
- Loss deemed to be cost of acquisition of the additional/ bonus units
- Applicable to units of a mutual fund specified u/s 10 (23D)

Implication

- 1000 Shares purchased @ Rs 30 each for Rs 30,000/= in Feb, 2005.
- In April, 2006 company issues bonus shares in the ratio of 1:1
- In June, 2006 the entire 2000 shares are sold @ Rs 15 each for Rs 30,000
- Calculation of capital gain/ loss:
  - Long term capital loss : Rs 15,000/=
  - Short term capital gain : Rs 15,000/=

Short term capital gains

- The assessee sells a plot of land for Rs 1.4 Cr which was acquired for Rs 1.0 Cr resulting in short term capital gains from sale of property Rs 40 lacs.
- 1 lac shares of Rs 10 each subscribed in a pvt ltd company at a premium of Rs 50 each
- The said pvt ltd company issues bonus shares 1:5
- Original 1 lac shares are now sold for Rs 10 each resulting in short term capital loss of Rs 50 lacs
- Whether gain of Rs 40 lacs above be offset against loss of Rs 50 lacs
- Ensure to be out of section 94(8)

Capital Gains/ Business Income

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Business

Section 2(13)

- Business includes any trade, commerce or any adventure or concerning the nature of trade, commerce or manufacture;
- The word Business is one of wide import and it means an activity carried on continuously and systematically by a person by the application of his labour or skill with a view to earning an income. Barendera Prasad v. I.T. Officer AIR 1981 SC 1047,1953.
- The concept business must potulate continuity of transactions. A single transaction of storage for sale does not constitute a business.
  R.P.Gupta v. State of Orissa AIR 1967 Ori 29,30

Capital Asset

Capital asset means property of any kind held by an assessee,whether or not connected with his business or profession, but does not include-

- Any stock in trade, consumable stores or raw materials held for the purposes of his business or profession;
- Personal effects, that is to say, movable property including wearing apparel and furniture, but excluding jewellery)held for personal use by the assessee or any member of his family dependent on him.

Circular No.4/ 2007

- Associated Industrial Development Company 82 ITR 586 (SC)

  Whether a particular holding of shares is by way of investment or forms part of the stock-in-trade is a matter which is within the knowledge of the assessee who holds the shares and it should, in normal circumstances, be in a position to produce evidence from its records as to whether it has maintained any distinction between those shares which are its stock-in-trade and those which are held by way of investment.

- H.Holck Larsen 160 ITR 67 (SC)

  Transactions in shares whether investment or trading is a mixed question of law & fact

- Fidelity Northstar Fund and Others

  288 ITR 641 (AAR)

Authority for Advanced Rulings

- Fidelity Northstar Fund and Others

  288 ITR 641 (AAR)
- 3 principles:
  - How shares valued/ held in the books
  - Magnitude, etc; finding ratio between purchase & sales & holding
  - Intention to derive income by way of dividends

Supreme Court

- G.Venkataswamy Naidu & Co v. CIT
  (1959) 35 ITR 594 (SC)

  Criteria to ascertain nature of income:

- Purchase/Sale allied to or incidental to his usual trade.
- Nature & quantity of purchase and sales
- Repetition of the transaction
- Test of intention;-only for resale

  -no intentions for holding the property for himself or enjoying or using it.
- Total effect of all the relevant factors & circumstances

Judicial precedents

- Raja Bahadur Visheshwara Singh v. CIT (1961) 41 ITR 685 (SC)
- Raja Bahadur Kamakhya Narian Singh v. CIT (1970) 77 ITR 253 (SC)
- Dalhousie Investment Trust Co. Ltd v. CIT (1968) 68 ITR 486 (SC)
- CIT v. H.Holck Larsen (1986) 160 ITR 67 (SC)
- CIT v. Sugar Dealers (1975) 100 ITR 424 (All.)

Draft Instructions dt 16/5/2006

- Whether the purchase and sale of securities was allied to his usual trade or business/was incidental to it or was an occasional independent activity.
- Whether the purchase is solely with the intention of resale at a profit or for long term appreciation and/or for earning dividends and interest.
- Whether scale of activity is substantial.
- Whether transactions were entered into continuously and regularly during the assessment year.
- Whether purchases are made out of own funds or borrowings.
- The stated objects in the Memorandum and Articles of Association in the case of a corporate assessee.
- Typical holding period for securities bought and sold.

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- Ratio of sales to purchases and holding.
- The time devoted to the activity and the extent to which it is the means of livelihood.
- The characterization of securities in the books of account and in the balance sheet as stock in trade or investments.
- Whether the securities purchased or sold are listed or unlisted.
- Whether investment is in sister/related concerns or independent companies.
- Whether transaction is by promoters of the company.
- Total number of stocks dealt in.
- Whether money has been paid or received or whether these are only book entries.

Principle of Consistency

- Janak S. Rangamala v. ACIT
  (2007) 11 SOT 627 (Mum)
  - Magnitude of transactions alone not relevant
  - Determination on the basis of books of accounts
  - Intention to be the decisive factor
  - Unless material change; principle of consistency to be applied
- Tribunal cannot give different decisions for different years
  Arihant Builders & Developers 277 ITR 239 (MP)
- Revenue did not challenge decisions in earlier years
  CIT v. Vikas Chemicals (India) 196 CTR 12 (P&H)

Final outcome

- Circular does not come up with any thing substantial except a categorical assertion that a taxpayer can have two portfolios

  CIT v. NSS Investment 158 Taxman 13 (Mad)
- Intention and the treatment in accounts are two important factors for determining the nature of income
- Principle of consistency
- No single criterion is decisive, total effect of the facts and circumstances of each case to be considered to determine the nature of income.

Thank you

Issues to be addressed

- Effect of loss under different situations:
  - Speculation
  - Investment
  - Business
  - F&O transaction
- Classification of income
- Dividend
- Expenditure for earning dividend
- Period of holding to be construed from the date of allotment of shares: effect thereof

Transfer

- Conversion of preference shares into ordinary shares is a transaction of the nature of "exchange"

CIT v. Trustees of H.E.H. the Nizam Trust

(1976) 102 ITR 248 (AP)

- Redemption of preference shares by the company comes under relinquishment of asset.

Anarkali Sarabhai v. CIT 90 Taxman 509 (SC)

- Reduction of share capital is chargeable in the hands of shareholders.

Kartikeya V. Sarabhai v. CIT 94 Taxman 164 (SC)

CIT v. G. Narsimhan (1999) 102 Taxman 66 (SC)