



WIRC – ICAI

Tax issues faced by investors and operators
in capital market

Presentation by
Yogesh Thar

May 27, 2016

Synopsis

- Business v/s. Capital Gains ;
- Speculative Income and Losses – a brief update ;
- Other losses / income in share transaction ;
- Some transfer pricing issues concerning share investments ;
- Some day-to-day assessment issues concerning shares and securities



BUSINESS INCOME v/s. CAPITAL GAINS

Presentation by: Yogesh Thar –WIRC May 27, 2016

Relevant Judicial Pronouncements & Legislations

Tests laid down in:

- Venkataswami Naidu v. CIT (35 ITR 594)(SC)
- Raja Bahadur Kamakhya Narain Singh v CIT (77 ITR 203) (SC)
- CIT v. Associated Industrial Development Co. (82 ITR 586)(SC)
- H. Mohammed & Co. v. CIT (107 ITR 637)(Guj)
- Instruction No. 1827 dated August 31, 1989;
- Circular - 4/2007 dated June 15, 2007;
- Circular no 6/2016 dated February 29, 2016 ;
- Easwar Committee Recommendations ;
- CBDT Letter F.No. 225/12/2016 dated May 2016

Tests summarised

- Considering the judicial pronouncements, instruction and circular mentioned above, the tests may be summarized as under:
 - Intention at the time of purchase;
 - Object Clause in MoA;
 - Treatment in books of account;
 - Method of valuation in accounts;
 - Quantum of purchase and sale;
 - Ratio between purchase and sales;
 - Period of holding ;
 - Frequency, continuity and regularity of transactions;
 - Source of Acquisition – whether from owned or borrowed funds;
 - It is possible to have two portfolios, one for investment and the other for stock-in-trade ;
 - Any act prior to purchase making showing a design or purpose

- Chart demonstrating the facts in various case laws involving shares and securities

Sr. no.	Criteria	Nailesh Dalal	Pargro Investment Pvt Ltd	S.K. Finance	Dhiraj Kenia	Bharat Kenia	Kunverji Kenia	Hriday Nailesh Dalal	Naishadh v. Vachharajani
1	Period of holding	over 6 months (avg)	1 to 9 months	106 days	107 days	116 days	124 days	over 6 months	2 to 5 months
2	No. of scripts purchased	41	79	51	129	142	213	25	2,00,066 shares traded
3	No. of scripts sold	49	79	49	105	168	173	25	
4	Value of purchases (Amt in lacs)	250.38	368.24	79.16	153.70	272.94	2008.45	21.38	104.33
5	Value of sales (Amt in lacs)	432.72	487.94	79.35	131.47	369.83	1059.95	23.90	117.81
6	No. of purchase days	49	56	315	261	236	177		222 transactions
7	No. of sale days	68	45	312	240	202	162		

Citations

- Case laws referred to in the Chart:
 - M/s Pargro Investments Pvt. Ltd. V. ITO (ITA No. 829/M/2010,ITA No.637/M/2010)
 - M/s S.K. Finance V .Dy.CIT(ITA No.6190/M/2008)
 - Bharat Kunverji Kenia V. ACIT (130 TTJ 86)
 - Kunverji Nanji Kenia V. ACIT (43 SOT 87)
 - ITO V. Hriday Nailesh Dalal (ITA No. 3469/M/2009)
 - ACIT V. Naishadh V. Vachharajani (ITA No.6429/M/2009)

Easwar Committee Recommendation

- Easwar Committee recommended that:
 - Shares and securities held for > 12 months – surplus arising on transfer chargeable as capital gains if not held as stock-in-trade;
 - Shares and securities held < 12 months – surplus arising on transfer, upto a sum of Rs. 5 lacs, will be chargeable as capital gains if they are not held as stock-in-trade.
 - Profits or gains arising to an assessee from transfer of shares or securities held for < 12 months and which have been offered to tax under the head “capital gains”, do not exceed Rs. 5 lacs during the previous year, the AO shall not treat such profits and gains as business income, provided the shares were not held as stock-in-trade.

Impact of Circular No 6/2016 and Letter F.No 225/12/2016

Types of shares/ securities	Listed			Unlisted
Classification	Assessee treats as S-I-T	Assessee treats as Capital Asset		
Period of which held		Held for less than 12 months	Held for more than 12 months	Irrespective of period of holding
Taxable as	Business Income	To decide based on established tests	Capital Gains	Capital Gains

- 1) Bogus transactions – to deal on merits – above circular not applicable ;
- 2) Transfer of unlisted shares requiring lifting of corporate veil – above circular not applicable;
- 3) Transfer of unlisted shares along with control and management – above circular not applicable

Income from PMS

Capital Gains v Business Income :-

- ↖ Radials International v CIT (Del)(HC) (367 ITR 1) [2015];
- ↖ CIT v Kapur Investments (61 taxman.com 91) (Kar) (HC)[2015]

Allowability of PMS Fees :

- ↖ Devendra Motilal Kothari v DCIT (132 ITD 173) (Mum) (Tribunal) - Against
- ↖ KRA Holding & Trading (P) Ltd. (46 SOT 19) (Tribunal) – Favor ;
- ↖ Pradeep Kumar Harlalka v ACIT (47 SOT 204) (Mum) (Tribunal) - Against;
- ↖ Homi K .Bhabha v ITO (48 SOT 102) (Mum)(Tribunal) - Against;
- ↖ Serum Institute of India Ltd v ACIT (ITA No.1576/PN/2012) (Tribunal)- Favor

Transfer of shares in amalgamation

- When shares are held as capital asset – section 47 exemption to the shareholder
- When shares are held as stock-in-trade – no exemption.
 - Case of hardship. Accretion getting taxed, while the law taxes only accrual or receipt.

Recent Protocol in Indo-Mauritius DTAA

- Effect of Indo – Mauritius Protocol signed on May 10, 2016:

Sr. No.	Date of acquisition of shares in an Indian Company.	Date of transfer of these shares	Rate of tax on Capital Gains in India
1.	Prior to 1-4-2017	Any time	Capital Gains continues to enjoy exemption in India in accordance with the present provisions of the Indo-Mauritius DTAA
2.	On or after 1-04-2017	Between 1-4-2014 and 31-3-2019	<p>a) <u>Case – 1</u> : i.e. LOB* conditions satisfied by the Mauritius entity: Capital Gains taxable in India at 50% of the applicable domestic tax rates.</p> <p>b) <u>Case – 2</u> : LOB conditions not satisfied by the Mauritius entity: Capital Gains taxable in India at the normal applicable domestic tax rates.</p>
3.	On or after 1-04-2019	After 31-3-2019	Capital Gain taxable in India at the normal applicable domestic tax rates.

* Limitation of Benefit Clause

Recent Protocol in Indo-Mauritius DTAA (contd)

- LOB clause:
 - Resident of Mauritius (including a shell/ conduit company) will not be entitled to benefits of 50% reduction in tax rate if it fails the main purpose test and bonafide business test;
 - Shell/ conduit company is any legal entity with negligible or nil business operations or with no real and continuous business activities carried out in Mauritius;
 - A resident shall be deemed to be a shell/conduit company if its total expenditure on operations in Mauritius is less than Rs 2,700,000 (Mauritian Rupees 1,500,000) in the immediately preceding 12 months.

Recent Protocol in Indo-Mauritius DTAA (contd)

- Applicable domestic tax rates on Capital gains:

Sr. No.	Residential Status of seller	Listed Shares		Unlisted Shares	
		LTCG	STCG	LTCG	STCG
1	Non-resident Indian – section 115E	Exempt – section 10(38)	15%	10%	Slab Rates*
2	Foreign Institutional Investors – section 115AD	Exempt – section 10(38)	15%	10%	Slab Rates*
3	Foreign Company	Exempt – section 10(38)	15%	10%	40%
4	Non-residents other than Foreign Company	Exempt – section 10(38)	15%	10%	Slab Rates*

* For the purpose of withholding tax at source the rate will be 30%

Recent Protocol in Indo-Mauritius DTAA (contd)

- Impact on FIIs resident in Mauritius:
 - The ambiguity of whether securities held by FIIs should be considered as ‘stock-in-trade’ or ‘business income’ was put at rest by amending the definition of ‘capital asset’ vide Finance Act (No. 2), 2014.
 - Relevant extract of section 2(14) of Income-tax Act:

“capital asset means—

 - (a) property of any kind held by an assessee, whether or not connected with his business or profession;*
 - (b) any securities held by a Foreign Institutional Investor which has invested in such securities in accordance with the regulations made under the Securities and Exchange Board of India Act, 1992 (15 of 1992),*

but does not include—

 - (i) any stock-in-trade [other than the securities referred to in sub-clause (b)], consumable stores or raw materials held for the purposes of his business or profession ;*

.....”
 - Effect of clause (b) read with clause (i)
 - Implications under MAT - Exempt
- Presentation by: Yogesh Thar –WIRC May 27, 2016

Implications under ICDS

- CBDT vide notification dated 31 March 2015 introduced 10 ICDS to be effective from 1 April 2015 and shall accordingly apply for AY 2016-17 onwards. ICDS VIII deals with shares and securities
- As per ICDS- VIII, securities held as stock in trade shall be valued at:
 - actual cost initially recognized; or
 - net realizable value at the end of that previous year, whichever is lower
- Valuation to be done on **category basis**, not individual basis. Valuation of unquoted shares to be done at **actual cost**

Valuation adopted under ICDS- Would result in timing difference

ICDS VIII – Securities – Analysis

- What would be the major impact of ICDS on securities, will it apply to NBFC?
 - NBFC has not been specifically excluded, hence ICDS will apply
 - Comparison of cost or NRV has to be done category wise not individual asset wise.

Individual Security	Cost	NRV	Valuation
Company P	150	20	20
Company Q	150	45	45
Company R	150	15	15
Company S	150	300	150
	600	380	230
Valuation (A.S.)			230
Valuation (under ICDS)			380



Speculative income and losses – a brief update

Some recent decisions

- **Lohia Securities Ltd v. DCIT 66 taxmann.com 86 (Kol-ITAT) dt. 9-12-2015**
 - Assessee is a share broker
 - Profit earned from F&O transactions :Rs. 35 crs
 - Loss incurred in Bad delivery shares (delivery based transactions) :Rs. 5 crs.
 - Held:
 - F&O is not speculative [clause (d) of proviso to sec. 43(5)]
 - Delivery based transactions is not speculative u/s 43(5)
 - Before applying *Explanation* to s. 73, first compute Business Profit [CIT v. Concord Commercials 95 ITD 117 (Mum)(SB)]
 - Net Business income being positive, Explanation to s. 73 has no application
 - Set off permissible
- Similar view in **DCIT v. Guinness Securities Ltd. 68 taxmann.com 375 (Kol)**

Some recent decisions (cont'd)

- **Deepak Sogani v. DCIT 68 taxmann.com 332 (Mum)**
 - ▶ Loss incurred in F&O : Rs. (55 lacs)
 - ▶ Short term capital gain on shares : Rs. 48 lacs
 - ▶ Held:
 - F&O is not speculative business income[clause (d) of proviso to sec. 43(5)]
 - STCL can be set off against business income [S. 71]
 - Set off allowable

Some other interesting decisions on section 73

- Whether a single transaction of purchase & sale of shares covered by the explanation?
 - According to Explanation 2 to section 28, unless speculative transactions constitute business, section 73 can not apply.
 - Case laws in favour of the above statement:
 - **CIT v. India Commercial Co. P. Ltd. [1977] 106 ITR 465 (Bom.)**
 - **ACIT v. Maggaji Sermal [1978] 114 ITR 862 (AP)**
 - Case laws against the above statement:
 - **CIT v. Bhikamchand Jankilal (131 ITR 554)(MP HC)**
 - **CIT v. Ganga Prasad Birla (HUF) [1993] (199 ITR 173) (Cal. HC)**
- Purchase of Shares vs. Application for allotment of shares
 - Purchase of shares do not include acquisition of shares through application for allotment of shares.



Other losses / income in share transaction

SIT Report on Black Money – July 24, 2015

- Report observes:
 - New allotment of shares by Companies
 - Sharp rise in prices of the scrip – caused by artificial trading (brokers / promoters collusion)
 - Sale of shares at high prices – earn tax free LTCG
 - A mode of conversion of black money to white without payment of tax
 - Need for SEBI to have effective monitoring and inform IT Dept
- A possible legal answer:
 - Intention at the time of purchase – to sell at a high profit – hence “adventure in the nature of trade”
 - LTCG exemption not available as income chargeable u/h “business”

Issue of shares at Premium

- Issue of shares at a premium and source of funds not explained – addition u/s. 68
- Amendment to section 68 – whether retrospective?
- If source explained, section 68 not applicable.
- If source explained – post section 56(2)(viib) – premium to comply with Rule 11UA benchmark
- Sale of shares at a loss – whether loss allowable as STCL?
 - One view : Loss is STCL and hence allowable for s/o or c/f as per law;
 - Other view: : Purchase and sale of shares is sham – hence, loss is not a loss u/h “Capital Gains”. Hence – loss u/h “Other Sources” – can’t be carried forward!
- Share premium taxed u/s. 56(2)(viib). Whether allowable as a deduction when utilised?
 - Utilisation for capital purposes (e.g. provide for issue of bonus shares)
 - Utilisation for revenue purposes (e.g. provide premium on debentures)

Other instances of losses and tax issues

- Loss on sale of shares by a non resident to a resident. Whether resident payer liable to TDS?
 - Transmission Corporation (SC)
 - GE Electronics(SC) / Vijay Ship Breaking (SC)
 - Hindustan Coca Cola (SC)
- Loss in the hands of the shareholder u/s. 46(2)?
 - Face Value of shares :Rs. 10/-
 - Amount of reserves per share :Rs. 5/-
 - Amount received on liquidation :Rs. 15/-
 - Cost of acquisition :Rs. 25/-
 - Commercial loss (25/- (-) 15/-) = :Rs. 10/-
 - Dividend taxable 5/-; Capital Loss 15/- c/f

Other instances of losses and tax issues

- Buyback of shares by unlisted companies:
 - Losses in the hands of the shareholders – whether allowable – s. 10(34A) r.w.s 115QA. Whether “income” includes loss?
- Buy –back of shares by listed companies :
as per Sebi Circular dated CIR/CFD/POLICYCELL/1/2015 dated April 13, 2015
- Long term capital Gains : Not taxable
- Long term capital loss – allowable ?
 - Raptakos Brett & Co. Ltd v DCIT (69 SOT 383) (Mum)(T)
- Short term capital gain – Taxable u/s 111 of the Act ;
- Short term capital loss – allowable
Presentation by: Yogesh Thar – WIRC May 27, 2016



Some transfer pricing issues concerning share investments

Inbound / Outbound Investment - Whether Transfer Pricing Provisions applicable

- Inbound Investments
 - **Vodafone India Services (P.) Ltd v. Union of India (368 ITR 1) (BOM)**
 - TP provisions only apply if there is chargeable income resulting from the transaction.
 - Capital investments, which do not create chargeable income, cannot therefore be brought within the scope of transfer pricing provisions;
- Outbound Investments
 - **M/s PMP Auto Components v DCIT (ITA 7724/Mum/2014)**
 - Investments in share capital outside India were in the nature of capital investments, and such transactions do not create chargeable income and hence cannot be brought within the scope of transfer pricing.



Some day-to-day assessment issues concerning shares and securities

Section 14A

- ▶ Shares held as stock-in-trade, whether s. 14A applies?
 - CIT vs. Indian Bank (56 ITR 77)(SC)
 - HDFC Bank Ltd. vs. DCIT (67 taxmann.com 42)(Bom HC)
- ▶ Easwar Committee Report
- ▶ Since DDT is to be grossed up, DDT is clearly the tax of the shareholder paid by the Company. Hence need to revisit Mafatlal Holding's decision.

Strategic Debt Restructuring Scheme by RBI

RBI has issued various guidelines for revitalizing the stressed assets in the economy :-Banks to convert existing loan into equity and are currently exempt from creating MTM (mark-to-market) provisions

Tax issues arising on such conversion of debt into equity :-

Transfer of shares by the debt holders – whether taxable as capital gain u/s 45

- Cost of acquisition of shares
- Method for computing the cost of acquisition

*DBR.BP.BC.No.82/ 21.04.132 / 2015-16



Thank You