

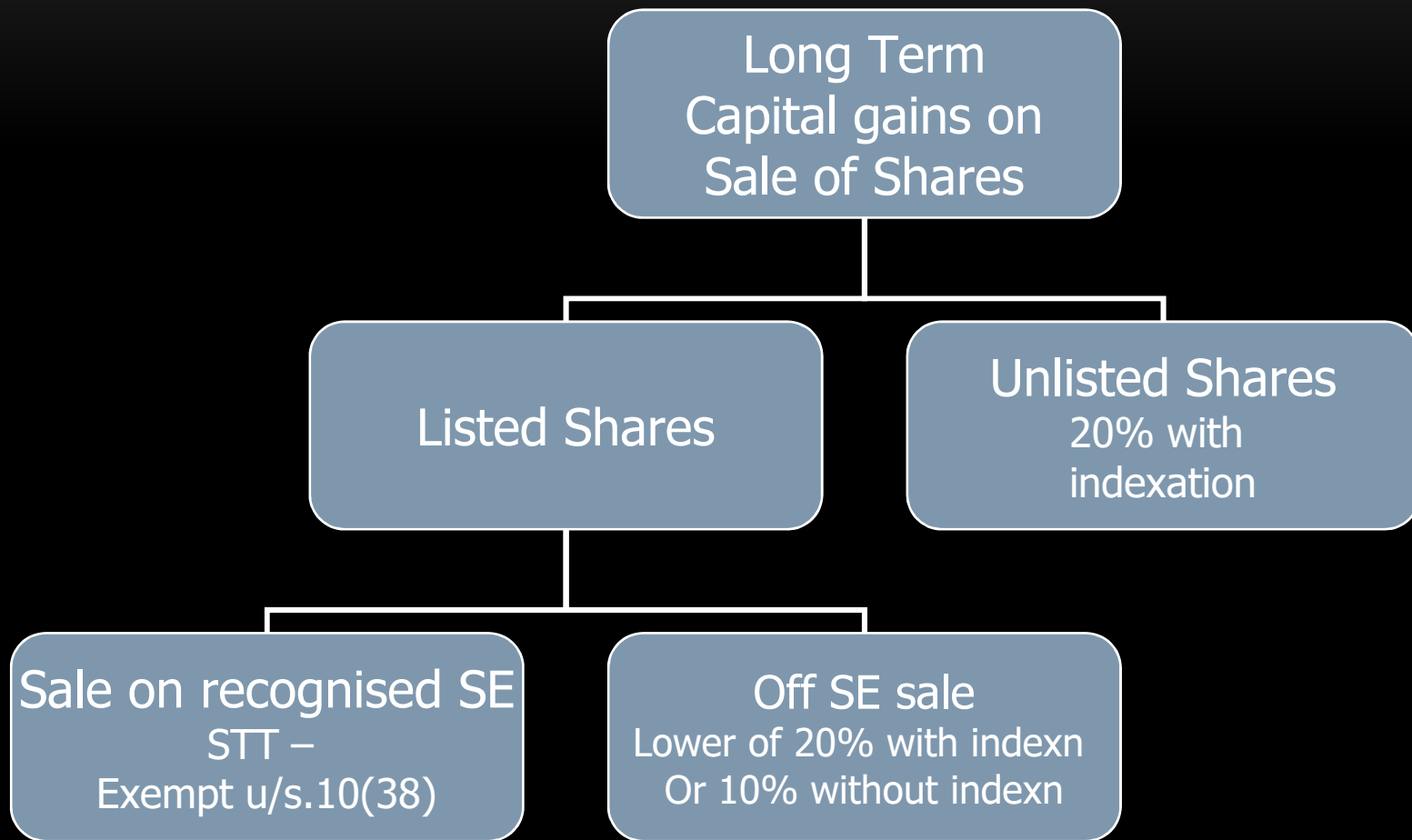
TAXATION OF SHARES & SECURITIES

CA. Gautam Nayak

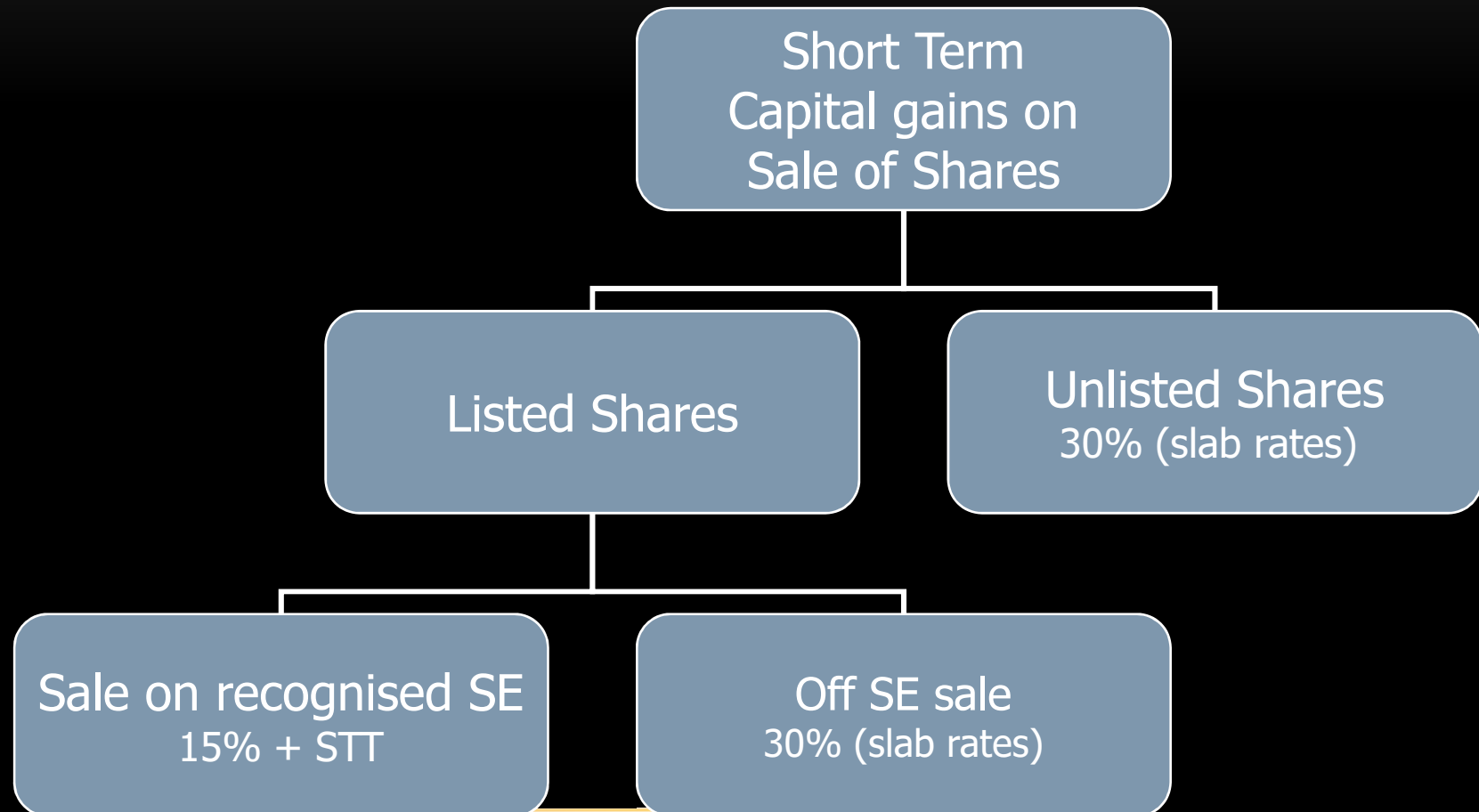
Seminar on Recent Updates
& Issues in Capital Gains

20th July 2013

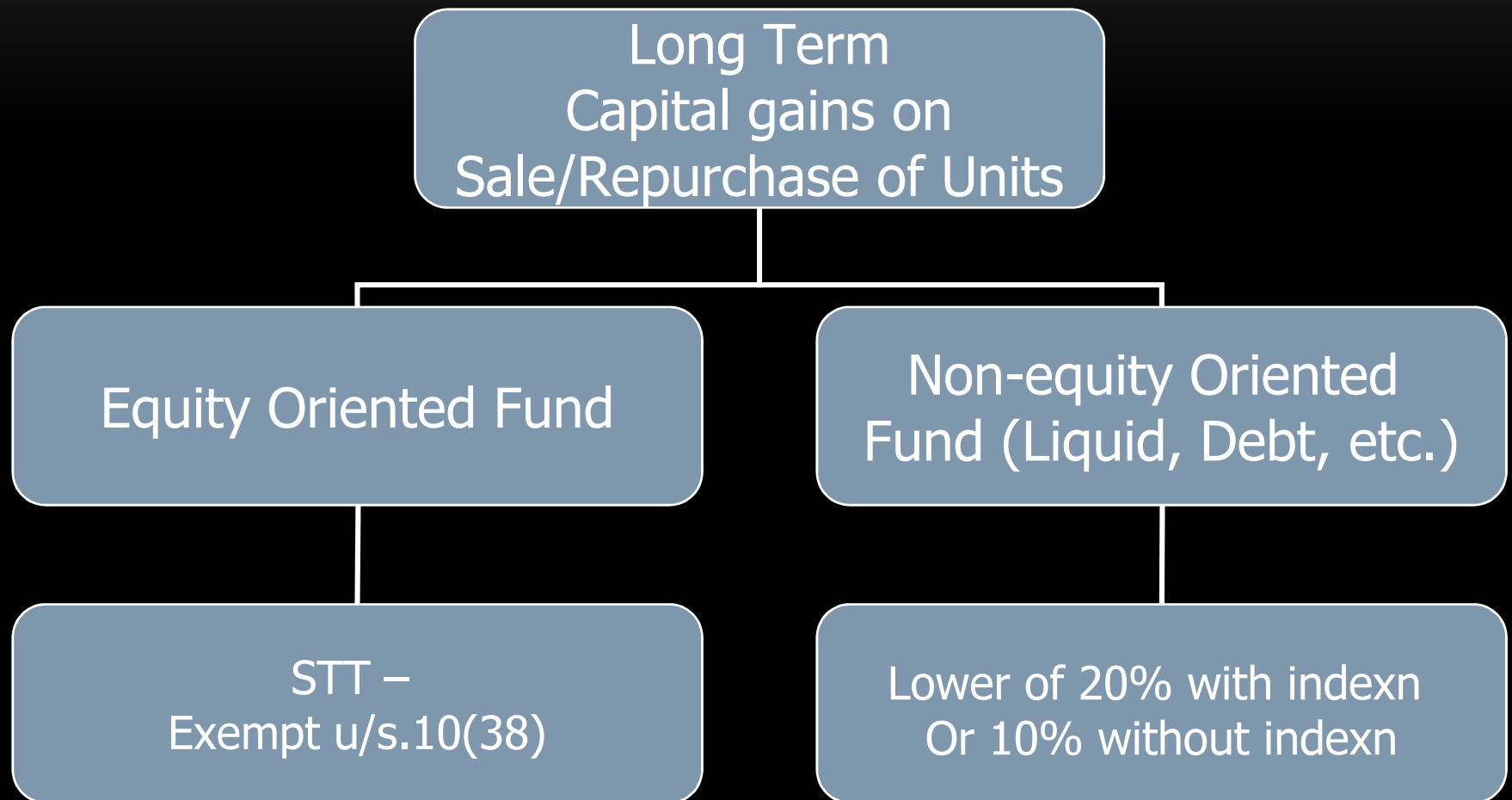
SHARE TRANSACTIONS – CAPITAL GAINS (LONG TERM)



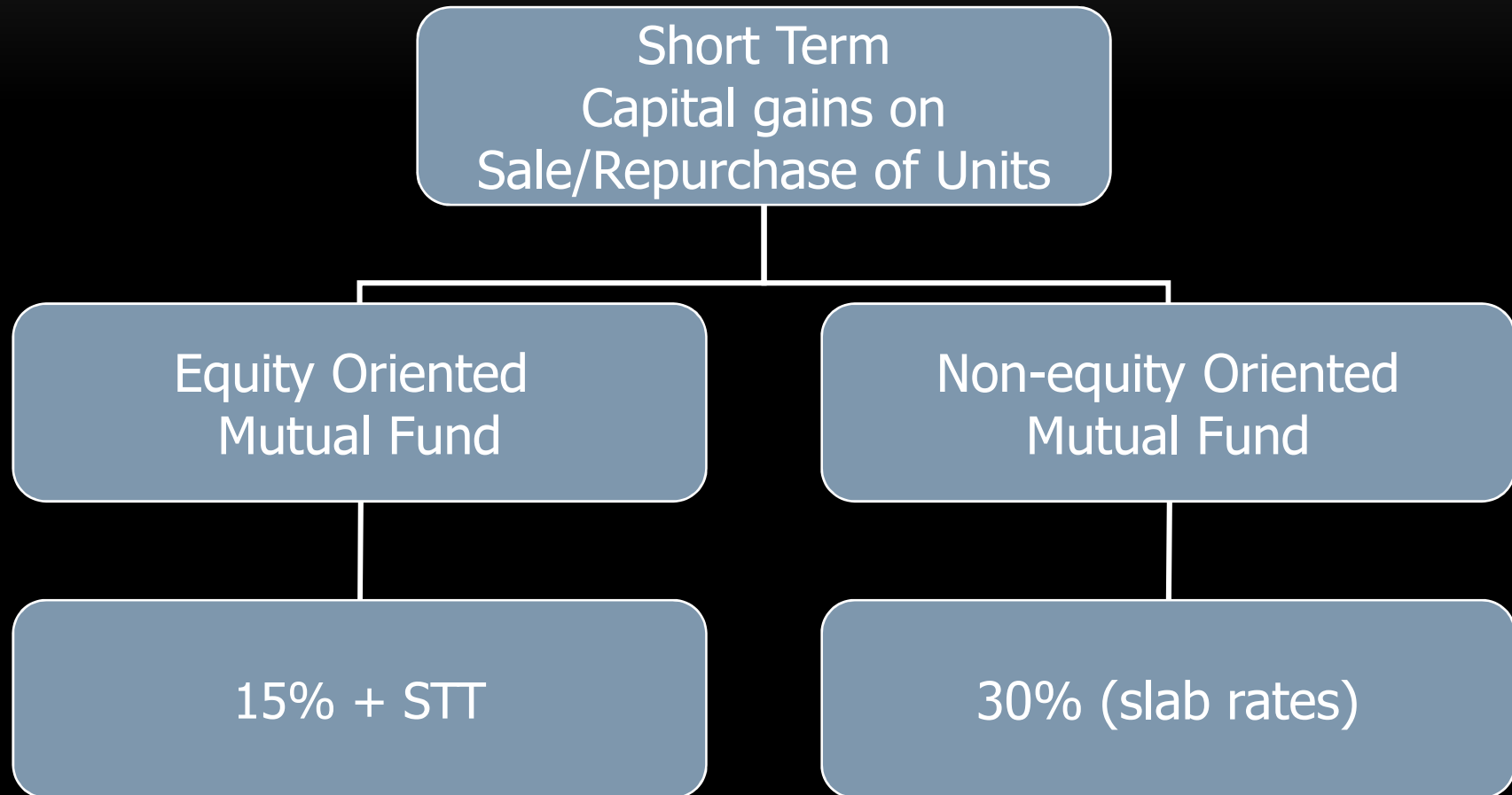
SHARE TRANSACTIONS – CAPITAL GAINS (SHORT TERM)



MUTUAL FUND UNIT TRANSACTIONS – CAPITAL GAINS (LONG TERM)



MUTUAL FUND UNIT TRANSACTIONS - CAPITAL GAINS (SHORT TERM)



EXEMPTION U/S.10(38)

- Whether applicable to sale through public offer?
 - Uday Punj v CIT 348 ITR 98 (Del)
- Whether available for block deals?
- Whether available for share buybacks?
- Whether applicable in loss situations?

TAX COMPUTATION

- Tax on each item of gains to be separately computed
- Option of 20% with indexation or 10% without indexation is only for computation of tax, not a computation of income
- Option to be exercised item wise
 - Devinder Prakash Kalra v. ACIT 151 Taxman 17 (Del)

POSITION OF LOSSES

- Can short term capital losses of on market trades be set off against normal short term capital gains?
- Is it mandatory to set off short term capital losses against taxable long term capital gains (which may be taxable at 20% or at lower of 10% or 20%)?
- Can indexed loss be set off against unindexed gains?
 - Mohanlal H Shah HUF v ACIT 26 SOT 380 (Mum)

BUYBACK OF SHARES

- Gains to be taxed as capital gains in case of listed shares – lower of 10% without indexation or 20% with indexation
- To be subject to Distributed Income Tax of 20% in the hands of the company in case of unlisted shares (wef 1.6.2013) – on difference between buyback price and amount received for issue of shares
 - May differ from gains to shareholder
 - Capital gains exempt u/s.10(34A)

BUYBACK OF SHARES

- Buyback of Shares where entire share capital held by holding company & nominees – whether exempt u/s.47(iv)
 - RST, in re, 348 ITR 368(AAR)
 - Under Indian law, a parent company cannot hold 100% in a subsidiary
 - Parliament did not intend to confer the benefit of s.47(iv) on such a parent company
 - Benefit must be confined to cases where a parent company holds 100% shares in an Indian subsidiary, through its nominees
 - S.46A being a special provision, prevails over s.47, being a general provision
-

REDEMPTION OF PREFERENCE SHARES

- Redemption by company is transfer
 - Anarkali Sarabhai v CIT 224 ITR 422 (SC)
- Benefit of Cost Indexation
 - CIT v Enam Securities P Ltd 345 ITR 64 (Bom)
 - Preference shares are not bonds or debentures – benefit of cost indexation available

REDUCTION OF SHARE CAPITAL

- Reduction of face value of shares without consideration being paid – whether capital loss
- Bennett Coleman & Co Ltd. v Addl. CIT 12 ITR (Trib) 97 (Bom)(SB)
- Only notional loss – percentage of shareholding unchanged – intrinsic value remains the same
- No change in cost of acquisition – s.55((2)(b)(v)
- S.45 not applicable – no cost of acquisition & no consideration

ZERO COUPON BONDS

- NABARD Bhavishya Nirman Bonds notified u/s.2(48)
- Invest Rs.8,750, receive Rs.20,000 on maturity after 10 years
- Notified by CBDT u/s.2(48)
- Difference received on maturity to be taxed as LTCG
- Taxable at 10% without indexation

BONUS STRIPPING

- Restriction on allowability of loss on bonus stripping in units – s.94(8)
- Not applicable to bonus stripping in shares
- Commercial risk – can be hedged through derivatives

CONVERSION OF PREFERENCE SHARES INTO EQUITY SHARES

- Not exempt u/s.47
- Addl. CIT v. Trustees of HEH Nizam's Second Supplementary Family Trust 102 ITR 248 (AP)
- Different rights & different capital assets
- Amounts to exchange
- S.55(2)(b)(v) – cost in case of conversion of one kind of shares of the company into another kind

CONVERSION OF STOCK IN TRADE INTO INVESTMENTS

- Whether conversion at cost/book value or at market price or any other price?
 - Period of Holding – whether to include period of holding as stock?
 - Cost for capital Gains – market price on date of conversion, conversion price or cost on acquisition as stock?
 - Cost Indexation – from which date?
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CONVERSION OF STOCK IN TRADE INTO INVESTMENTS – CASE LAW

- Sir Kikabhai Premchand v. CIT 24 ITR 506 (SC) – no man can make profit out of himself – drawings of stock in trade
- CIT v. Dhanuka & Sons 124 ITR 24 (Cal) – Loss arising on transfer of shares from trading account to investment account is not allowable

CONVERSION OF STOCK IN TRADE INTO INVESTMENTS – CASE LAW

- **Kalyani Exports & Investments P. Ltd. v. Dy. CIT 78 ITD 95 (Pune)(TM), confirmed in CIT v. Janhavi Investments (P) Ltd. 215 CTR (Bom) 72**
 - Asset cannot be acquired first as a non-capital asset and later as a capital asset – only one acquisition when first acquired – Ramchhodbhai Bhajibhai Patel v. CIT 81 ITR 446 (Guj), Keshavji Karsondas v. CIT 207 ITR 737(Bom)
 - Cost on first acquisition to be taken as cost
 - Period of holding from date of first acquisition
 - Indexation from date of first acquisition

CONVERSION OF INVESTMENTS INTO STOCK IN TRADE – CASE LAW

- Point of Time of Conversion – *ACIT v. Jehangir T. Nagree* 23 SOT 512 (Mum)
 - Conversion of shares from investment into stock in trade on first day of year
 - Loss claimed to be business loss, profit on conversion treated as gains u/s.45(2)
 - AO held that business not carried on by assessee on date of conversion – treated as capital loss
 - Sweet will of assessee to decide when he desires to convert investment into stock-in-trade
 - Considering huge volume, held to be business loss
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CONVERSION OF INVESTMENTS INTO STOCK IN TRADE – CASE LAW

- **Fact of Conversion – Milestone Finance & Leasing Co. Ltd. 14 SOT 55(Del)**
 - Shares classified as investments in audited accounts till end of earlier year
 - Letter filed before AO that investments converted into stock in trade
 - Loss on conversion claimed as business loss, AO held as capital loss u/s.45(2)
 - Subsequent claim that misclassified in accounts earlier – really stock in trade from inception
 - Held that conversion had taken place
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SHARE TRANSACTIONS – CAPITAL GAINS OR BUSINESS?

- CBDT Instruction No.1827 dated 31.8.1989
- Draft CBDT Instructions of May 2006
- CBDT Circular No.4 dated 15.6.2007
- Case Law

SHARE TRANSACTIONS – CBDT INSTRUCTION NO.1827 OF 1989

- G. Venkataswami Naidu & Co. 35 ITR 594 (SC) – various tests
- H. Mohammed & Co. 107 ITR 637 (Guj) – selling outright vs. deriving income from exploitation
- Sardar Indra Singh & Sons Ltd. 24 ITR 415 (SC) – connection with assessee's business
- SBH 151 ITR 703 (AP) – connection with business
- Karam Chand Thapar & Bros. P. Ltd. 82 ITR 899 (SC) – accounting treatment not conclusive
- Decision ultimately on facts of each case

SHARE TRANSACTIONS – DRAFT CBDT INSTRUCTION OF MAY 2006

1. Whether purchase & sale of securities allied to usual trade or business / incidental to it or occasional independent activity
 2. Whether purchase made solely with intention of resale at profit or for long term appreciation and/or for earning dividends & interest
 3. Whether scale of activity substantial.
 4. Whether transactions entered into continuously & regularly during the year.
 5. Whether purchases made out of own funds or borrowings
 6. Stated objects in Memorandum and Articles of Association of a corporate
 7. Typical holding period for securities bought and sold
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SHARE TRANSACTIONS – DRAFT CBDT INSTRUCTION OF MAY 2006

8. Ratio of sales to purchases and holding
 9. Time devoted to the activity and extent to which it is the means of livelihood.
 10. Characterization of securities in books of account and in balance sheet as stock in trade or investments.
 11. Whether securities purchased or sold are listed or unlisted.
 12. Whether investment is in sister/related concerns or independent companies.
 13. Whether transaction is by promoters of the company.
 14. Total number of stocks dealt in.
 15. Whether money has been paid or received or whether these are only book entries.
- Total effect of all factors to be considered
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CAPITAL GAINS V. BUSINESS INCOME

Draft CBDT Instruction of May 2006

- Mere draft, not actually issued
- Factors culled out from various case laws
- Supported by Press Release
- Though not binding on AO, can act as a guide to deciding issue
- Referred to in a few decisions

SHARE TRANSACTIONS – CBDT CIRCULAR NO.4 OF JUNE 2007

- Whether investment or stock-in-trade is matter within knowledge of assessee
- Whether investments or trading transactions mixed question of fact and law
- Power in MoA not decisive
- Substantial nature of transactions, magnitude of purchases and sales, and ratio between purchases & sales & holding are good guide
- Motive of earning profit vs. objective of deriving income by dividend
- Possible to have both investment & trading portfolio

SHARE TRANSACTIONS – CASE LAW

- **G. Venkataswami Naidu & Co. 35 ITR 594 (SC)**

“We thus come back to the same position and that is that the decision about the character of a transaction in the context cannot be based solely on the application of any abstract rule, principle or test and must in every case depend upon all the relevant facts and circumstances.”

SHARE TRANSACTIONS – CASE LAW

- **Janak S. Rangwalla v. ACIT 11 SOT 627(Mum)**
 - Short term capital gains of Rs.1,47,15,196
 - Long term capital loss of Rs.1,02,31,691
 - Reflected in Balance Sheet as investment
 - Similar transactions treated as capital gains in earlier years
 - Magnitude of transaction does not alter character of transaction
 - No basis for treating as trader
 - Held to be investments and capital gains

SHARE TRANSACTIONS – CASE LAW

- J.M. Share & Stock Brokers Ltd. v. Jt. CIT (ITA No.2801-02/Mum/2000 dated 30.11.2007)
 - Short term capital gains of Rs. 2.12 cr. & long term capital gains of Rs. 4.45 cr.
 - Both investments & stock-in-trade shown separately
 - Capital gains & business income taxed separately in earlier years
 - Resolution passed for investments
 - 20% of investments in unquoted equities/debentures
 - 25% of investments through new issues
 - No bar on share brokers holding investments
 - Held to be taxable as capital gains
-

SHARE TRANSACTIONS – CASE LAW

- Sarnath Infrastructure (P) Ltd. v. ACIT 120 TTJ (Luck) 216
- Principles
 - Intention at time of purchase of shares – treatment in books
 - Interest bearing borrowing to fund purchase
 - Frequency of purchases & disposal – ratio between purchases & sales and holding
 - Purchase & sale – whether for realising profit or for retention & appreciation
 - Method of valuation – at cost or lower of cost and net realisable value
 - Objects of company and resolutions
 - Distinction kept by assessee in two types of holdings & intermingling
 - Mere fact of credit in particular account not decisive
 - Compliance with legal requirements of trading

SHARE TRANSACTIONS – CASE LAW

- **Gopal Purohit v. JCIT 122 TTJ (Mum) 87**
 - Engaged in the activity of sale and purchase of shares for quite a long period
 - Non delivery based transactions treated by assessee as business activity and delivery based transactions treated as investment activity
 - STCG – Sale of 7,59,003 shares for Rs.5,00,12,879
 - LTCG –Sale of 3,88,797 shares for Rs.6,65,02,340
 - Claim of declaring himself both as investor and dealer accepted by Revenue authorities in earlier years.
 - Different view by AO in current year - even shares held as investment assessed as business income

SHARE TRANSACTIONS – CASE LAW

- **Gopal Purohit v. JCIT 122 TTJ (Mum) 87 ...**
 - Open to assessee to keep two separate portfolios
 - Nature of activities, modus operandi, manner of keeping records and presentation of shares as investment is same in all the years
 - Investment can be an organised activity
 - Investor bound to study newspapers, magazines, watch business channels, use websites, take assistance of consultants – use of such infrastructure cannot convert investment activity into business activity
 - Claim of the assessee accepted on grounds of consistency

SHARE TRANSACTIONS – CASE LAW

- **CIT v. Gopal Purohit 336 ITR 287 (Bom)**
 - Pure finding of fact
 - Correct application of principles of law
 - Open to an assessee to maintain two separate portfolios for investment & trading
 - Consistent practice in nature of activities, manner of keeping records and presentation of shares as investment
 - Uniformity in treatment & consistency when facts are identical, particularly for same assessee
 - Entries in books of account not conclusive in determining nature of income
 - Correct principles applied by Tribunal
 - **CIT v Naishadh Vachharajani ITA (L) No 1042 of 2011 dated 22.9.2011 (Bom HC) – similar view**
-

SHARE TRANSACTIONS – CASE LAW

- **Suresh Kumar Seksaria v. ACIT [2010] 1 ITR (Trib) 783 (Mum)**
 - Volume & no. of transactions is not decisive in understanding true nature of transactions – depends on quantum of investments - if large funds invested, obviously volume & no. of transactions will be high
 - If both purchase and sale of same shares within same year- might be an indication of trading in shares
 - If large sale in respect of shares acquired long before, not trading
 - Shares sold – shown as investment in the year of their acquisition - Classification as “investments” was accepted by Dept. in that year.
 - Nature of investments could not be changed in the year of sale
 - Held to be ~~taxable as capital gain~~

SHARE TRANSACTIONS – CASE LAW

- Management Structure & Systems Pvt. Ltd. 41 DTR (Mum) (Trib) 426
 - Engaged in management consultancy, investment advisory and equity research services
 - LTCG Rs.99.11 lakh, STCG Rs.19.83 lakh
 - In past, no trading – always treated as investments
 - 83% of gains was LTCG
 - 78% of LTCG from Infosys - held for 62 to 71 months - mostly bonus shares
 - No transactions in derivatives
 - Substantial dividend of Rs.7.86 lakh received
 - Held to be capital gains
-

SHARE TRANSACTIONS – CASE LAW

- **Sadhana Nabera v. ACIT 41 DTR (Mum)(Trib) 393**
 - Director/Substantial shareholder in family companies engaged in share trading
 - STCG before 1.10.2004 Rs.0.45 lakh, after 1.10.2004 Rs.79.74 lakh (mainly in 5 scrips)
 - Transactions of 2,12,281 shares involving purchase of Rs.1.87 crore, sale of Rs.2.69 crore
 - Intra-day trading also with nominal loss
 - Loans from banks and family companies
 - Low investments & LTCG in earlier years
 - Held to be business income

SHARE TRANSACTIONS – CASE LAW

- **CIT v. Niraj Amidhar Surti 347 ITR 149 (Guj)**
 - Chartered Accountant with substantial investment in shares
 - Borrowed funds for one investment @ 30%
 - Shares held for 14 months
 - Shares sold in one lot
 - Sales proceeds invested in Capital Gains bonds
 - Held to be Capital Gains

SHARE TRANSACTIONS – CASE LAW

- CIT v. S. Ramaamirtham (2008) 306 ITR 239 (Mad)
 - Share & stock broker
 - Trading in shares in business, investing in personal account
 - Investments held for a long time
 - Only surplus invested in shares
 - Held to be Capital Gains

SHARE TRANSACTIONS – CASE LAW

- **Vinod K. Nevatia v. ACIT 49 DTR (Trib)(Mum) 16**
 - Broker trading and investing in shares
 - Separate books of account & separate demat accounts
 - LTCG of Rs.2.37 cr accepted
 - STCG of Rs.47 lakhs from 14 scrips
 - Majority STCG holding period of more than 6 months
 - No borrowing attributable to investment
 - Held to be STCG

SHARE TRANSACTIONS – CASE LAW

- **Nehal V. Shah v. ACIT (ITA No.2733/Mum/2009 dated 15.12.2010)**
 - Business of Garment manufacture & export
 - STCG of Rs.1.08 cr – through PMS
 - 88% of shares sold purchased during the same year
 - Only 31 purchase and 25 sale transactions (multiple transactions in day treated as 1 transaction)
 - Unrealised gain of Rs.6 cr at year end
 - No borrowing
 - Held to be capital gains
-

SHARE TRANSACTIONS – CASE LAW

- **ACIT v. Sheela Chiniwala 9 taxmann.com 279 (Mum. ITAT)**
 - 60 year old housewife
 - LTCG of Rs.91 lakhs (98 tr), STCG of Rs.67 lakhs (395 tr in 142 scrips)
 - LTCG accepted, STCG taxed as business income
 - Intention at time of purchase to be seen – same purchase cannot be treated partly as investment & partly as stock depending upon subsequent sale
 - Held to be STCG

SHARE TRANSACTIONS – CASE LAW

- Nagindas P. Sheth HUF v. ACIT (ITA No.961/Mum/2010 dated 5.4.2011)
 - 158 transactions – no intra-day squaring up
 - STCG of Rs.36.5 lakhs (Rs.28 lakhs more than 30 days, Rs.8.5 lakhs for less than 30 days)
 - Treated as investor in earlier year
 - Held to be STCG

CAPITAL GAINS V. BUSINESS INCOME

- **Some Practical Hints**

- In computing number of transactions, treat all sales on one date as one transaction, though purchased on different dates
 - Examine reasons for large sales
 - Purchase of property or expensive asset
 - Large Personal expenses
 - Change of Portfolio Manager
 - Considerable fast appreciation
 - Fear of large fall in market
 - Rebalancing of portfolio
-

CAPITAL GAINS V. BUSINESS INCOME

- **Units of Open Ended Mutual Funds**

- Till recently, such units not traded on market & non-transferable
- Even now, sale in market is means of surrender to mutual fund for repurchase
- Repurchase necessarily at NAV – no market price independent of NAV based repurchase price
- Appreciation in NAV reflects accrued earning on investment, and not separate appreciation in value of mutual fund
- Stock-in-trade necessarily indicates capability of sale – freely tradable
- CBDT Draft Instruction of May 2006 – listed or unlisted

PORTFOLIO MANAGEMENT SCHEMES

- Appointment of Portfolio Manager – Impact on tax treatment as investment/business
 - Appointment of Agent
 - Agent infrastructure v. own infrastructure
 - Purpose of appointment of agent
 - Discretionary PMS – full freedom to PMS Manager – mere reporting to investor on regular basis

PORTFOLIO MANAGEMENT SCHEMES

- **Churn by Portfolio Manager – Impact**
 - Mere increase in volumes not determinative
 - All other factors need to be considered – Sar investment Pvt. Ltd. v. Dy. CIT 40 SOT 566 (Ahd)
 - Larger volumes may be due to:
 - Modifying earlier investments to adhere to PMS Manager strategies
 - Responding to changes in market environment – rebalancing of portfolio
- **Category of Portfolio Strategy**
 - Buying risky shares does not change an investor into businessman
 - Strategy based on risk appetite of individual

PORTFOLIO MANAGEMENT SCHEMES

- Case Laws
 - ARA Trading & Investments P Ltd v Dy CIT 47 SOT 172 (Pune)
 - Cannot be said to be trading by the client – objective to maximise investment value
 - When neither the purchase nor sales are decided by the assessee but for that purpose the portfolio manager is assigned, then the term "dealing" cannot be attached with the assessee
 - Radials international v ACIT 49 SOT 567 (Del)
 - Portfolio manager has carried out trading in shares on behalf of his clients to maximize the profits
 - Shares were traded by the portfolio manager as an agent on behalf of the assessee
-

PORTFOLIO MANAGEMENT SCHEMES

- **Deductibility of Fees**
 - No difficulty for business
 - Structure of Fees
 - Fixed fee
 - Fee as percentage of portfolio
 - Fee linked to performance
 - Combination of above
 - Example - 1% of portfolio value plus 20% of return in excess of 6%
 - Fee linked to return is really either for purchase (cost) or for sale (expenses in connection with transfer)
 - Pro rate over LTCG, STCG and Dividends
-

PORTFOLIO MANAGEMENT SCHEMES

- **Deductibility of Fees.....**
 - Held Deductible
 - KRA Holding & Trading P Ltd v Dy CIT 46 SOT 19 (Pune)
 - Held not deductible
 - Devendra Motilal Kothari v Dy CIT 50 DTR (Mum)(Trib) 369
 - Pradeep Kumar Harlalka v. Asstt. CIT 143 TTJ (Mum) 446
 - Homi K Bhabha v ITO 48 SOT (Mum) 102

UNITS OF MUTUAL FUNDS

- **Switch-in Switch-out**
 - Dividend reinvestment to Regular Dividend or vice-versa – no transfer
 - Growth to Dividend option
 - Same scheme in MF accounts – different NAV
 - Different rights
 - Not only fundamental attributes, but various rights, including right to dividend
 - Conversion of preference to equity – Trustees of HEH Nizam's Second Supplementary Family Trust 102 ITR 248 (AP) – equity to preference – Santosh L Chougule 234 ITR 787 (Mum)
 - Subject to STT
-

UNITS OF MUTUAL FUNDS

- **Merger of Schemes – whether transfer**
 - Option to exit provided to investors
 - Investor consciously chooses to remain and be allotted units of different scheme
 - Rights of new scheme significantly different from rights in merging scheme
 - STT charged

TAXATION OF DERIVATIVES

- Can derivatives be Capital assets?
 - Nature of Derivatives
 - Whether distinct from underlying shares
 - CIT vs. Tata Services Ltd. 122 ITR 594 (Bom)
 - Whether any advantage in treating derivatives as Capital assets?
 - 15% rate u/s.111A not available
 - Hedging transactions
 - Purchase and sale in case of futures sales
-

TAXATION ON PHYSICAL SETTLEMENT OF DERIVATIVES

- **For Investor**
 - Whether derivatives transaction and subsequent share purchase/sale part of the same transaction or separate transactions?
 - If separate, whether transfer of derivatives on physical settlement?
 - If separate, whether income/loss from derivatives to be computed separately and not to be adjusted in cost/sale price of shares?
 - Loss on lapsing of option – whether allowable as capital loss?
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DERIVATIVES

- **Delivery Settled Derivatives**

- Right to purchase asset resulting in delivery of asset
- Whether transfer of derivative and acquisition of share or merger of existing right into asset?
- Derivative and share separate assets so long as delivery not taken
- Merger into asset on delivery
- Right to purchase asset & asset – rights entitlements & rights shares
- Arjan Khimji & Co 121 ITR 421 (Bom) not applicable – contracts held to be not connected
- Date of delivery would be date of acquisition of share
- Cost would be amount paid for derivative plus amount paid on delivery

DERIVATIVES

- **Allowability of Loss on Lapsing of Options**
 - Dy. CIT v. BPL Sanyo Finance Ltd. 312 ITR 63 (Karn) – Forfeiture of share application money allowable as capital loss
 - CIT v. Chand Ratan Bagri 329 ITR 356 (Del)- Forfeiture of amount paid towards convertible warrants – capital loss deductible
 - Ajay C Mehta v Dy CIT 114 ITD 628 (Ahd) - extinguishment of warrants amounts to transfer – however no consideration accruing as a result of transfer – computation provisions fail – capital loss not allowable
 - JHP Securities P Ltd v ITO ITA No 1249/Mum/2008 dated 8.2.2012 – conversion of warrants into shares does not give rise to transfer
-

INDIAN DEPOSITORY RECEIPTS

- Securities but not equity shares
- Not subject to STT
- Period of holding for LTCG - 12 months
- STCG taxable at normal rates of tax
- LTCG not exempt u/s.10(38) – taxable at lower of 20% with indexation or 10% without indexation (proviso to s.112)

THANK YOU!

