

Tax exemptions on share transactions

To make a balance with the changing needs, provisions of the Income Tax Act are changed from time to time. This article throws light on the recent amendments in provisions relating to taxation of capital gains and conformation of AS-13 with tax law. This amendment has resolved many issues but some terms and conditions are there which must be understood to have full-fledged benefit from these provisions.



The Finance (No.2) Act, 2004 had accorded major tax concessions to share transactions. Long-term capital gains (LTCG) arising from the sale of equity shares in a company has been made tax exempt by virtue of insertion of a new section 10 (38) provided that such transaction is chargeable to securities transaction tax. Further, short-term capital gains (STCG) on shares are now subject to concessional tax treatment at 10 per cent, subject again to chargeability to securities transaction tax. This boosted the market sentiments and the share market registered major gains in the aftermath. However, there is a little realization in the stock market and professional fraternity that the aforesaid exemptions/concessions may not be available for the asking.

The revenue department may

be perfectly justified by law in denying the exemption/concessional treatment to tax in many cases and treating them as cases of business income, which is subject to tax at the normal rate of taxation.

CBDT has issued instructions, being instruction no.9 and 10, both dated 20.9.2004, stating that all cases, where income exceeding Rs.10 lakhs in the case of a corporate assessee or Rs. 2 lakhs in the case of a non corporate assessee are claimed as exempt, shall be taken up for compulsory scrutiny.

Thus, the government is conscious of the fact that either the assesseees are not following the law of the land in making claims of



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exemption or camouflaging their unaccounted income as exempt incomes. So, before joining the stock market bandwagon for claiming dollops of exempt income, remember the maxim—“look before you leap.”

It is pertinent to note that during the greater part of the period, when the Indian Income Tax Act of 1922 was in vogue, there was no levy of capital gains tax. Even under the 1961 Act, concessional treatment has always been accorded to LTCG. Therefore, the law on the subject is fairly settled with a catena of judgements from the highest Court of the country available.

AS-13 conforms to tax law but...

It is normally felt that the manner of depiction in the accounts is

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conclusive in the matter of treatment of gains arising from share transactions for taxation purposes. Chartered Accountants follow AS-13 issued (in September 1993) by the Council of the ICAI in regard to the Accounting for Investments. True to the spirit of paragraph 4.1 of the “Preface to the statements of Accounting Standards (Revised 2004)”, AS-13 is also in conformity with the provisions of the applicable law, that is, the Income-tax Act. Thus, the term current investment [which is synonymous with the term “short term capital asset”(STCA) as defined in sec. 2(42A) of the Income-tax Act, 1961] as per AS-13 means an investment intended to be held for not more than one year, exactly the same period as a STCA (being shares) is required to be held.

The definition of long term investment (as per AS-13) is also exactly the same as provided for in respect of long term capital asset in section 2(29A) of the Income-tax Act. The term “investment” as defined in AS-13 is wide enough to match its counterpart “capital asset” as defined in section 2(14) of the Act except that section 2(14) provides for some more specific exclusions. Moreover, both the terms exclude stock-in-trade from their ambit.

In spite of such a striking similarity, can it be said that there is no material difference between the accounts prepared in conformity with AS-13 and the computation of Income required to be made for taxation purposes in regard to share transactions?

The answer is “NO”.

The reason lies in the definition of “business” as per the Income-tax Act. Section 2(13)

defines business as— “It includes any trade, commerce or manufacture or any adventure or concern in the nature of trade, commerce or manufacture”.

Any transaction falling within the definition of “business” is chargeable to tax under section 28 as profits and gains of business or profession. Thus, “an adventure in the nature of trade” even if not a regular business of the assessee, shown in the accounts as “Investment” as per AS-13 and profit or loss thereon shown as profit or loss on sale of investment in the accounts, is still chargeable to tax as business income.

The Supreme Court in *Raja Bahadur Kamakhya Narain Singh’s case 77 ITR 253* observed that when a person sells his investment and realizes an enhanced price, the excess is not a profit assessable to tax. But it would be so, if an act is done for making profits. But in the same breath, the Supreme Court observed: “The distinction between the two types of transactions is not always easy to make. If the transaction is in the ordinary line of the assessee’s business, there would hardly be any difficulty in concluding that it was a trading transaction, but where it is not, the facts must be properly assessed to discover whether it was in the nature of trade”.

In the case of *Investment Ltd. vs. CIT (1970) 77 ITR 533*, the Supreme Court held that description in the Balance Sheet is not decisive. The facts before the apex court were that the assessee had



incurred loss on sale of government securities, which were shown in the Balance Sheets as “investments”. The assessee claimed the loss arising out of such securities as business loss and claimed set-off with other income. The ITO denied the claim holding that the loss was capital in nature based on the facts, inter alia, that in the balance sheets the securities were shown as “investments” and were not valued at market value although it was less. In that context, the Supreme Court observed that no inference may be drawn from the employment by the company of the method of valuing stock at cost. The description of stock in the balance sheet as “investments” is not decisive. The Supreme Court finally held, after analyzing the facts and circumstances, that the loss incurred was a business loss.

Similar view was expressed by the Calcutta High Court in *CIT vs. Shree Krishna Properties Ltd. (1992) 205 ITR 308* relying upon the judgement of Investment Ltd. vs. CIT (Supra).

One sparrow may make summer

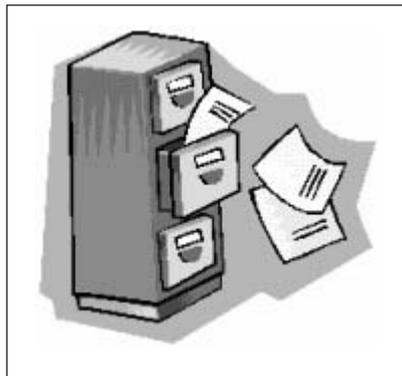
It is said that appearance of one

sparrow does not make a summer. This principle may not apply for the purpose of determining whether a single/isolated transaction falls into the realm of “trade” or “business”. The term “adventure in the nature of trade” connotes a stray operation. Therefore, in *G. Venkataswami Naidu & Co. vs. CIT (1959) 35 ITR 594*, the Supreme Court observed that sometimes it is said that a single plunge in the waters of trade may partake of the character of an adventure in the nature of trade. The Supreme Court went on to add that this statement may be true; but in its application due regard must be shown to the requirement that the single plunge must be in the waters of trade. In other words, at least some of the essential features of trade must be present in the isolated or single transaction. Thus in view of the Supreme Court assessability of a single transaction as business income is not ruled out.

In *CIT vs. Central Kurkhend Coal Co. Ltd. (1978) 113 ITR 483*, the Calcutta High Court was *in seisin* of a case where the central issue was treatment of a solitary transaction as a business loss. Here the facts were that the assessee—company entered into a single solitary transaction of purchasing 7,000 unquoted shares of one company. Hefty dividend was declared immediately after the purchase of shares. The assessee company sold all the shares within two months of the purchase and incurred loss in the purchase-sale transaction but on the over all basis, after taking dividend into consideration, there was a surplus. Dispute arose as to the nature of loss.

The Calcutta High Court, after examination of the entire facts and

circumstances, held that the loss was in the nature of “business loss”. As a matter of fact, the Court noted that the shares were held in the name of a bank which showed that the intention of the assessee was not to hold the shares for a long time. Further, the object of the assessee, according to the Court, was to make a quick profit by way of dividends by the purchase of shares immediately after the declaration of dividend.



Tests for determining “trade”

In *CIT vs. Holck Larsen (1986) 160 ITR 67*, the Supreme Court quoted with approval the report of the Royal Commission on Taxation of profits and income of England, which was presented to the Parliament of United Kingdom in 1955. The Royal Commission was considering whether a simple test could be evolved that can determine whether subject matter involves trading/dealing or investment. In its report, the Royal Commission observed that there cannot be any single fixed rule and each case must be decided according to its own circumstances. Accordingly, it was suggested that it should be seen whether a transaction that is said to give rise to a taxable profit bears any of the “badges

of trade”. The Royal Commission sought to identify the “**badges of trade**” as follows-

- (1) **The subject-matter of the realisation.** While almost any form of property can be acquired to be dealt in, those forms of property such as commodities or manufactured articles, which are normally the subject of trading are only very exceptionally the subject of investment. Again property which does not yield to its owner an income or personal enjoyment merely by virtue of its ownership is more likely to have been acquired with the object of a deal than investment.
- (2) **Length of period of ownership:** Generally speaking, property meant to be dealt in is realised within a short time after acquisition. But there are many exceptions to this as a universal rule.
- (3) **Frequency of similar transactions by same person:** If realisations of the same sort of property occur in succession over a period of years or there are several such realisations at about the same date, a presumption arises that there has been dealing in respect of each.
- (4) **Supplementary work on or in connection with property realized:** If the property is worked up in any way during the ownership so as to bring it into a more marketable condition; or if any special exertions are made to find or attract purchasers, such as the opening of an office or large-scale advertising, there is some evidence of dealing. For, when there is an organised effort to obtain profit,

there is a source of taxable income. But if nothing at all is done, the suggestion tends the other way.

(5) **Circumstances that were responsible for realization:**

There may be some explanation, such as a sudden emergency or opportunity calling for ready money, that negatives the idea that any plan of dealing prompted the original purchase.

(6) **Motive.** There are cases in which the purpose of the transaction of purchase and sale is clearly discernible. Motive is never irrelevant in any of these cases. What is desirable is that it should be realised clearly that it can be inferred from surrounding circumstances in the absence of direct evidence of the seller's intentions and even, if necessary, in the face of his own evidence."

The Calcutta High Court examined the case of an isolated transaction on the touchstone of various tests to determine whether the transaction involved trade/adventure in the nature of trade in *Radha Debi Jalan vs. CIT (1951) 20 ITR 176*. In this case, one Smt. Radha Debi Jalan alongwith some other ladies purchased 48,000 shares of a Jute Mill. Out of 48,000 shares, Radha Debi purchased 4,300 shares on 27th May, 1940. All these holdings, including Radha Debi's, were sold at a profit in March, 1945. The question before the Court was whether the profit on such transaction was a casual or non-recurring receipt, not chargeable to tax or profit derived from business having tax implications. The Court held as follows-

"When the person concerned in an isolated transaction from which

he makes a profit is a man carrying on business in certain other lines, the task of deciding whether the transaction is or is not a trade is comparatively easy. It is not so easy in the case of a person in the position of any of the ladies in the present case who is not a businessman at all. What will be the test in the case of an isolated transaction by such a person? Unfortunately, of the several tests applied in the different cases to be found in the books, none will be applicable here. One test is to see whether the thing purchased is such as is likely to give the purchaser a **pride of possession** so that he might like to hold and cherish it as a thing which is worth possessing for its own sake for whether the thing purchased is such as must necessarily be sold off. The subject matter in the present case is a block of shares and with respect to shares it cannot be said that they confer a pride of possession, nor can it be said that they must necessarily be sold off.

A second test is whether the bulk of the commodity purchased is so large that in order to sell **it the must necessarily have resource to some organisation and activity of the kind that it required in trade.** The shares in the present case are only 4,000 to ten or fifteen thousand in number and it can by no means be said that in order to sell off such blocks of shares any organisation is necessary. Nor has any organisation been found. A third test is whether the thing purchased is such as must **be subjected to**



some processing for the purpose of making it marketable, and that test again will not apply. shares do not require to be converted and cannot be converted into any other form for the purposes of sale. We must therefore fall back upon the only one test which remains, viz., **was there any intention to turn the commodity over**, as it were, for the purpose of making profit and was there any activity applied to it which was of the nature of trade?"

On this aspect, the Court observed that the fact that the shares were held on for five years does not, to say the least, point to trading.

In *Investment Ltd. vs. CIT (1970) 77 ITR 533 (SC)*, the assessee—company had claimed loss suffered in the sale of securities as a business loss, which was disallowed by the ITO holding that no part of the business of the Company was to deal in securities. The Supreme Court in this case carefully considered the circumstances of the case relied upon by the Tribunal and came to the conclusion that the claimed loss was allowable as a business loss. The circumstances that weighed in the

mind to the Supreme Court to come to the above conclusion were – (a) The objects clause of the Memorandum of the company permitted investment, subscription and dealing in shares and securities. (b) The Company effected transactions of sale and purchase of shares and securities of large magnitude in the earlier years and the year in question and (c) In the earlier years, the ITO held that the shares and the securities were the stock-in-trade of the company and the loss was a permissible allowance under the business head.

In ***CIT vs. Sulej Cotton Mills Supply Agency Ltd. (1975) 100 ITR 706 (SC)***, the facts of the case were that the assessee company subscribed for 3,49,000 shares of a group company viz., Gwalior Rayon in the year ending December 31, 1951. In the accounting year ending on March 31, 1956, it sold a part of its stock of shares at a profit. The ITO assessed the same as a business income whereas the

assessee contended that the amount represented capital gain as the shares were purchased by way of investment and the same cannot be taxed as revenue receipt.

The Supreme Court upheld the contention of the revenue and supported the order of the Tribunal, but reversed the judgement of the High Court. In supporting the revenue's contention, the Supreme Court noted that the following facts found by the Tribunal indicated that the "adventure was in the nature of trade"- (a) In an earlier year, the assessee dealt in the shares of Titaghur Mills Ltd., though an isolated transaction, but the loss incurred in the transaction was claimed as "business loss" and was allowed as such. (b) Resolutions were passed authorizing one of the directors to deal in the shares (c) No dividend was declared by M/s Gwalior Rayon in the years preceding sales. (d) The assessee had borrowed money to purchase shares. Court noted that it is improbable

that the assessee would be investing borrowed money on which interest would have to be paid on the shares which yielded no dividend.

Similarly, in ***Dalhousie Investment Trust Co.'s case (1967) 68 ITR 486***, Supreme Court upheld transactions to be in the nature of business transactions on the basis that (a) return on investment was very low. (b) Shares were sold at considerable profit. (c) Objects in the Memorandum authorized such business and (d) Loans had been taken to purchase shares.

Conclusion

While filing the return of income, one has to correctly compute his income under the proper head and determine and pay the correct tax. Otherwise, one is visited with interest and penal liability. Some difficulty may be faced in the practical application of principles developed by the Courts in as much as no straitjacket formula could be evolved by the Courts. ■

Corrigendum

Attention is drawn to the "Appendix" of the Article namely, "Networking, Merger, Demerger, Corporate Form of Practice and Brand Building of CA Firms" by Shri Manoj Fadnis, FCA published in the Journal, December 2004 issue at pages 804-805. In the said Appendix, implication of earlier Council decisions on Change in Firm name/Seniority of Firms as prepared by the Study Group on Capacity Building Measures of CA Firms was published at pages 804-805. At page 805, in the table bearing heading 'Example', at third column i.e., 'Name of new Firm' of the second & fourth row, the firm names have been printed as 'A & Co.' & 'Either AB & Co. or' respectively. The Names of the firm may be read as 'B & Co. and 'Either AB & Co. or BA & Co.' respectively.

The table 'Example' may be read as follows: -

Example:

Name of firm	Name of new firm	Seniority	Date of Effect
A & Co., 1966	B & Co., 1980 A & Co.	Date of establishment will be 1966	27.2.1999
A & Co., 1966	B & Co., 1980 B & Co	Date of establishment will be 1980	27.2.1999
A & Co., 1966	B & Co., 1980 Y & Co	Date of establishment will be date of approval of Y & Co. by the Institute or constitution of the Partnership firm, whichever is later.	27.2.1999
A & Co., 1966	B & Co., 1980 Either AB & Co. or BA & Co.	Date of establishment will be 1966	4.2.2002

Further at page 804, the heading of the Appendix was printed as 'Implications of Earlier Council Decision or on Change in Firm name/Seniority of firms'. The same may be read as 'Implications of Earlier Council Decisions on Change in Firm name/Seniority of firms'.