Amendments Related to Capital Market Transactions

Loans or advance by a closely held company to its shareholders having more than 10% voting power is deemed as dividend u/s. 2(22)(e) and taxable in the hands of the shareholders. Finance Bill, 2018 proposes a new regime of taxing such deemed dividend in the hands of the company itself by way of distribution tax by amending section 115-O. Implications of the proposed amendments are discussed in this article. Exemption u/s. 10(38) in respect of LTCG on STT paid transactions has been withdrawn w.e.f. 01.04.2018 and a new section 112A is introduced to tax such gains at 10%. Existing appreciation till 31.01.2018 has been grandfathered. The article examines various issues that may emerge from the proposed section and also various hardships which may be faced in certain cases. As the new regime of taxation of LTCG may result into an unfavorable tax treatment to unit holders of growth plan of an equity oriented mutual fund vis a vis unit holders of dividend plan, Distribution tax of 10% is proposed to be imposed on income distributed by equity oriented mutual funds.

Finance Bill 2018 has been tabled in the Parliament with 53 Clauses related to Direct Taxes. The present article analyses certain proposed amendments relating to Capital Market Transactions and allied matters.

1. Deemed Dividend u/s. 2(22)(e)

1.1 Sub-Clause (e) of Section 2(22), which applies to closely held companies, covers the following three transactions in the definition of dividend:-

i. Loan or advance to a shareholder, having beneficial ownership of shares carrying 10% or more voting power in the company (hereinafter referred to as 'such shareholder').

ii. Loan or advance to a concern in which such shareholder has a substantial interest.

iii. Any payment on behalf of or for the individual benefit of such shareholder.

The above amounts are treated as dividend to the extent of accumulated profits of the company.

1.2 At present Dividend Distribution Tax u/s. 115-O is not leviable on deemed dividend u/s. 2(22)(e). Consequently, such dividend is not exempt u/s. 10(34) and is taxable in the hands of the shareholder at the applicable marginal rate of taxation.

1.3 Practically, the present structure poses difficulties for the department to tax the deemed dividend in the hands of the shareholder as generally the fact of such loan or advance is noticed by the Assessing Officer having jurisdiction over the company, but he may not have jurisdiction over the shareholder and hence recourse had to be

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made to Section 147 by Assessing Officer having jurisdiction over the shareholders.

1.4 Further, there has been long time pending controversy as to whether such deemed dividend is to be taxed in the hands of the 'shareholder' or in the hands of 'the concern', in situation mentioned in para 1.1(ii) above.

1.5 To overcome these difficulties, Finance Bill 2018 has shifted the taxation of deemed dividend u/s. 2(22)(e) from the shareholders to the company giving such loan or advance, by way of distribution tax. The Explanation to Section 115-Q is proposed to be omitted w.e.f. 01.04.2018. This Explanation provided that for the purpose of provisions relating to levy of Dividend Distribution Tax, the term 'Dividend' shall not include dividend referred to in Sub-Clause (e) of Section 2(22). With the omission of this Explanation, the term dividend shall have the meaning assigned to it in Section 2(22) i.e. all the five Sub-Clauses.

1.6 The salient features of the substituted regime of taxation of deemed dividend u/s. 2(22)(e) is as below:

i. It is liable to DDT @30% plus surcharge @12% plus Health & Education Cess @4%.

ii. Grossing up provisions of Section 115-O are not applicable to deemed dividend u/s. 2(22)(e), so the effective rate of DDT is 34.944%.

iii. Such DDT is to be paid within 14 days of payment of such loan or advances. In case of non-payment, interest @1% for every month or part of month is chargeable u/s. 115P. Further the company and the principal officer thereof shall be deemed as assessee-in-default.

iv. In the hands of the shareholder/the concern, such dividend is exempt u/s. 10(34).

v. Section 115BBDA defines dividend as excluding dividend u/s. 2(22)(e). Therefore, deemed dividend shall not be hit by the proviso to section 10(34) even if the amount of loan or advance is more than ₹10 lakh. It will continue to remain exempt u/s. 10(34).

1.7 The proposed amendment is effective from 1st April, 2018. Hence, all the loans or advances by a closely held company given on or after 1st April, 2018, will come under the purview of Dividend Distribution Tax. The Tax Auditor has to comment on the applicability of Section 115-O, in clause 36 of Form 3CD. Therefore, all the closely held companies and their auditors need to bear in mind the implications of the proposed amendment and the existing jurisprudence on Section 2(22)(e).

Finance Bill 2018 has proposed a new Section 112A levying 10% tax on long term capital gain on transfer of units of Equity Oriented Mutual Funds, calculated without indexation benefit. This new regime tilts the taxation in favour of a unit-holders of a dividend plan of Equity Oriented Mutual Funds.

2. Income Distribution Tax on Equity Oriented Mutual Funds

2.1 The existing provision of Section 115-R providing for tax on income distributed by mutual funds is not applicable on Equity Oriented Mutual Funds. Dividend received by Equity Oriented Mutual Funds, is already liable to distribution tax u/s. 115-O in the hands of the domestic companies declaring such dividend. In the hands of the unit holder, income received from Equity Oriented Mutual Funds is exempt u/s. 10(35), and long term capital gains on 'transfer' of such units is exempt u/s. 10(38). Thus, from taxation point of view; long term investor of dividend plan or growth plan of Equity Oriented Mutual Funds are at par.

2.2 Finance Bill 2018 has proposed a new section 112A levying 10% tax on long term capital gain on transfer of units of Equity Oriented Mutual Funds, calculated without indexation benefit. This new regime tilts the taxation in favour of unitholders of a dividend plan of Equity Oriented Mutual Funds. Unit holders of growth plan would be liable to 10% tax on the appreciation in NAV realised by them at the time of transfer of units, whereas unit holders of dividend plan would not be liable to any tax (neither in their hands nor in the hands of fund by way of distribution tax) on the distribution of appreciated NAV by way of dividend by the Equity Oriented Mutual Fund.

2.3 Therefore, to bring a level playing field between the dividend plan and growth plan of Equity Oriented Mutual Fund, Section 115-R is proposed to be amended to levy 10% tax on income distributed by the Equity Oriented Mutual Fund. This is, it is claimed, to make it at par with 10% tax on LTCG u/s. 112A. However, grossing-up provisions are applicable to income

distributed by Mutual Funds. Hence the effective rate of distribution tax on Equity Oriented Mutual Fund is higher than the proposed tax on LTCG on transfer of units of Equity Oriented Mutual Fund.

2.4 Further the definition of Equity Oriented Mutual Fund has been substituted.

The existing definition of Equity Oriented Mutual Fund u/s. 115-T is as below:-

"equity oriented fund" means—

(i) .....; and

(ii) such fund where the investible funds are invested by way of equity shares in domestic companies to the extent of more than sixty-five per cent of the total proceeds of such fund :

....."

The proposed definition of Equity Oriented Mutual Fund u/s. 115T is as below:-

"equity oriented fund" means a fund referred to in clause (a) of the Explanation to section 112A and the Unit Scheme, 1964 made by the Unit Trust of India;'

As per clause (a) of the Explanation to section 112A-

"equity oriented fund" means a fund set up under a scheme of a mutual fund specified under clause (23D) of section 10 and,—

(i) in a case where the fund invests in the units of another fund which is traded on a recognised stock exchange,—

(A) a minimum of ninety per cent. of the total proceeds of such fund is invested in the units of such other fund; and

(B) such other fund also invests a minimum of ninety per cent. of its total proceeds in the equity shares of domestic companies listed on a recognised stock exchange; and

(ii) in any other case, a minimum of sixty-five per cent. of the total proceeds of such fund is invested in the equity shares of domestic companies listed on a recognised stock exchange:

.....;"

The implication of the above substitution of definition of Equity Oriented Mutual Fund is explained below:-

i. Under the existing regime, a fund of funds was liable to distribution tax @30% or 25% depending upon the type of unitholder.

ii. Under the proposed regime, if a fund of funds falls in the definition of Equity Oriented Mutual Fund by fulfilling the criteria specified above, it will be liable to income distribution tax only @10%, whereas if it doesn't fulfill the criteria specified above, it will be liable to income distribution tax @30% or 25%, depending upon the type of unitholders.

3. Taxation of Long Term Capital Gains (LTCG) [Section 10(38) and 112A]

3.1 LTCG arising on transfer of following long term capital assets is exempt from tax u/s. 10(38) subject to certain condition specified therein:

a. Equity Share of a Company.
b. Unit of Equity Oriented Fund.
c. Unit of a Business Trust

It is now proposed to insert a proviso in section 10(38) to provide that the exemption will not apply to transfer effected on or after 1st April, 2018. Thus, the existing exemption u/s. 10(38) continues for transfer effected upto 31st March, 2018. For transfer of above specified assets after 31st March, 2018, a new Section 112A is proposed to be inserted levying 10% tax on such gains exceeding ₹1,00,000/-.

3.2 Salient features of proposed section 112A:-

3.2.1 It applies to transfer on or after 01.04.2018.

3.2.2 It applies to transfer of long term capital assets being:

a. Equity Share of a Company.
b. Unit of Equity Oriented Fund.
c. Unit of a Business Trust

(Hereinafter these Capital Assets shall be referred to as specified capital assets.)

3.2.3 In case of equity shares, this section applies only if Securities Transaction Tax (STT) has been paid at the time acquisition as well as transfer of such shares. In case of units of Equity Oriented Mutual Fund and units of business trusts, this section applies if the STT has been paid on transfer of such assets.

3.2.4 However, central government is empowered to issue a notification providing for situations where this section will apply even if no STT is paid at the time of acquisition of equity share in a company. In the FAQ dated – 4th February, 2018, CBDT has mentioned that this notification will be on the lines of the existing notification

no. 43/2017 dated 5th June, 2017 issued u/s. 10(38).

3.2.5 Further, the condition of STT having been paid is also not applicable in case of transfer undertaken on a recognised stock exchange located in International Financial Services Centre (IFSC), if the consideration for transfer is received or receivable in foreign currency.

3.2.6 The LTCG shall be calculated without giving effect to the first and second proviso to Section 48. First proviso to Section 48 allows the benefit of calculating capital gain in foreign currency to Non-Residents. Second proviso to Section 48 given the benefits of indexation in case of long term capital assets other than bonds and debentures. Since the normal tax rate on LTCG is 20% and in this case a lower rate of 10% is proposed, the above two benefits are denied while applying the new regime of taxation.

3.2.7 No deduction under chapter VI-A shall be allowed from the LTCG so computed. Even the rebate u/s. 87A shall not be allowed from the tax payable under this section. However, the benefit of unexhausted basic exemption limit in case of resident individual and HUFs is allowable against the LTCG computed under this section.

3.2.8 Tax rate proposed is 10% on such gains exceeding ₹1,00,000/-. Applicable surcharge (based on the total income) and Health & Education cess of 4% is also applicable on the tax computed under this section.

4. Issues Arising from Proposed Section 112A

4.1 <u>10% Tax on entire gains or on gains in excess of ₹1,00,000/-</u>

The first and foremost issue that arises is whether 10% tax rate is to be applied on whole of the gains, if it exceeds ₹1,00,000/- or it should be applied to gains in excess of ₹1,00,000/-. From the Finance Minister's speech and other interaction with media, it appears that the intention is to tax LTCG in excess of ₹100,000/- only. E.g., if the LTCG is ₹1,20,000/-, only ₹20,000/- is liable to tax @10%. However, the question that then arises is– about the taxability of first of ₹1,00,000/- of LTCG. Since exemption u/s. 10(38) is proposed to be withdrawn for transfer effected on or after 1st April, 2018, entire LTCG of ₹1,20,000/- is part of the total income and hence liable for tax by virtue of Section 4. If only the excess gain of ₹20,000/- is taxed u/s. 112A, the first ₹1,00,000/- of LTCG would be part of the total income and liable to tax either at normal tax rate or u/s. 112 – which again provides a rate of 10% without indexation under the proviso to Section 112(1). This appears not to be the intention of the legislature and hopefully this anomaly will be removed while passing the Finance Bill, by amending Section 10(38) so as to deny exemption only to LTCG in excess of ₹1,00,000/-, so that the first ₹1,00,000/- of LTCG will be exempt from tax.

4.2 <u>Retrospective or Prospective:-</u>

Before the introduction of Finance Bill 2018, LTCG on specified assets was fully exempt from tax u/s. 10(38). The withdrawal of this exemption could have been retrospective or prospective. If the proposed amendment would have taxed the entire gain arising on or after 1st April, 2018, it would have been in one sense retrospective law– as people have already acted on the promise of exemption u/s. 10(38) and altered their position by purchasing specified assets. Therefore, the principle of promissory estoppel would have emerged in the new regime and would have lead to the challenge to its constitutionality. A purely prospective regime would have been to withdraw the exemption in respect of LTCG arising on transfer of specified assets acquired after presentation of the Finance Bill i.e. 1st February, 2018. However, the Finance Minister has proposed– what can be called a retrospectively prospective regime. It is proposed to grandfather the gains accrued till 31st January, 2018. Hence, the regime can be called as retrospectively prospective. Retrospective– as it applies to shares already acquired before introduction of

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the Finance Bill 2018 and Prospective– as it is taxing only the incremental gains as compared to the value as on 31st January, 2018.

4.3 Grandfathering the LTCG accrued till 31st January, 2018.

4.3.1 In order to protect the unrealised gains accrued till 31st January,2018, it is proposed to provide that in case of specified assets acquired before 1st February, 2018, Cost Of Acquisition (COA) shall be taken as **higher** of the following:-

a) Actual Cost of Acquisition

b) **Lower of**:

i. Fair Market Value of Such asset and

ii. Actual full value of consideration.

4.3.2 For this purpose, Fair Market Value is determined as below:-

(i) In a case where the specified capital asset is listed on any recognised stock exchange, the highest price of the capital asset quoted on such exchange on the 31st day of January, 2018.

If there is no trading in such asset on such exchange on 31st day of January, 2018, the highest price of such asset on such exchange on a date immediately preceding the 31st day of January, 2018 when such asset was traded on such exchange shall be the fair market value.

(ii) in a case where the capital asset is a unit (unit of Equity oriented Mutual Fund, Unit of Business Trust) and is **not listed** on a recognised stock exchange, the net asset value of such asset as on the 31st day of January, 2018;

The above formula will ensure two things, if the highest price on 31.01.2018 is more than the actual COA, it will substitute the actual COA and so only the appreciation in the price above the highest price will be liable to tax. At the same time, if the actual selling price is lower than the highest price, one cannot claim an exempt gain till the highest price and thereafter a loss for the fall in price below the highest price. Following illustration will explain the application of the above formula:-

Case	Cost (₹)	Day High on 31/01/2018	Selling Price	Profit	Exempt Amt.	Taxable Amt.
1.	100	300	400	300	200	100
2.	100	300	250	150	150	0
3.	100	80	70	(30)	0	Loss 30
4.	100	80	90	(10)	0	Loss 10

4.4 Computation of Long Term Capital Loss

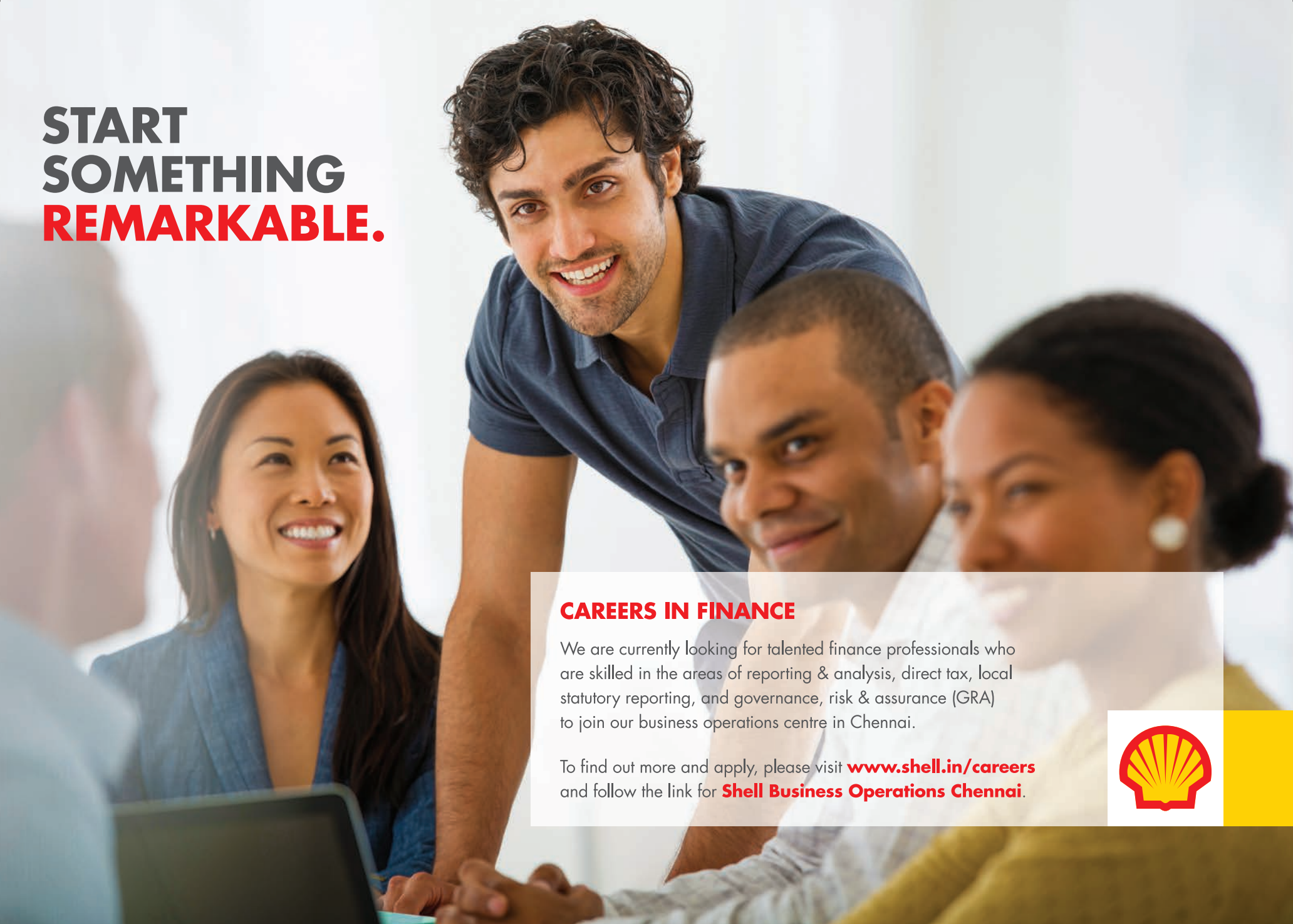
4.4.1 Since the exemption provided u/s. 10(38) is proposed to be withdrawn for transfer effected on or after 01.04.2018, any long term capital loss suffered shall be available for set off against other LTCG. However, the question arises as to the computation of long term capital loss for transfer effected on or after 1st April,2018. Sub-Section (5) of proposed Section 112A provides that the LTCG on specified assets shall be computed without the benefit of indexation. Hence, one view is that both gain and loss, shall be computed without indexation.

4.4.2 However, it can also be argued that loss shall be computed after claiming indexation of COA. This view is based on the following reasonings.

i. As per Section 2(45) 'total income' is defined to mean *"total amount of income referred to in Section 5, computed in the manner laid down in this Act"*. Chapter IV- deals with computation of total income. Since there is no amendment in Section 48 dealing with computation of capital gain, capital gain are to be first computed in ordinary manner, claiming indexation of Cost Of Acquisition.

ii. Section 112A is inserted in chapter XII titled as 'Determination of Tax in certain special Cases'. Thus, this Section deals only with determination of tax liability and not with computation oftotal income.

iii. Sub-Section (1) of Section 112A applies if the total income includes any income chargeable under the head "Capital Gain". In a case where the computation as per Chapter IV-E, results into a loss, the total income does not include income chargeable under the head "Capital Gain". Sub-Section (5) denying the benefit of indexation is only for the purpose of determining Capital Gain under Sub-Section (1) and in case of loss, Sub-Section (1) itself does not apply.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Therefore, there is nothing in Section 112A to deny the benefit of indexation in case of capital loss.

4.5 Specified capital assets acquired by any mode of acquisition u/s. 49(1)

4.5.1 Another difficulty in the proposed Section 112A is in a situation where a Specified Capital Asset is acquired by an assessee by any of the modes of acquisition referred to in Sec.49(1), on or after 1st February, 2018. Sub-Section (6), which deals with the grandfathering of appreciation upto 31st January, 2018 is applicable where the assessee has acquired the specified Capital Assets before 1st February, 2018. Hence, in case the ownership is transferred by one of the modes of acquisition referred to in Section 49(1) (gift, will, inheritance etc.), Sub-Section (6) may not strictly apply.

4.5.2 By virtue of Sec. 49(1), the assessee would get the benefit of Cost of Acquisition of previous owner and by virtue of Explanation 1 to section 2(42A), the assessee will also get the benefit of period of holding of previous owner.

Hence, the specified capital asset may still be regarded as long term by including the period for which they were held by the previous owner. However, due to absence of specific reference to Sec.49(1) in Sub-Section (6) of Sec. 112A, it may be difficult to claim the benefit of Sec. 112A(6). It seems to be an unintended result and hopefully it will be cured with the passage of the Finance Bill.

4.6 Equity shares listed on or after 31st January, 2018

The grandfathering of appreciation in price of equity shares till 31.01.2018 is measured with reference to the highest price quoted on any recognised stock exchange on 31.01.2018. Therefore, in a situation where equity shares of a company are listed after 31.01.2018, the provision of Section 112A(6) will fail and the whole of the capital gain measured from the original cost of acquisition will become liable to tax.

5. Other Issues

5.1 Security Transaction Tax (STT) was introduced by Finance (No.2) Act, 2004 in lieu of capital gain tax. With introduction of STT, Long Term Capital Gain was made exempt from tax under section 10(38) and Short Term Capital Gain was made taxable at a concessional rate of 15%. Even after the removal of exemption u/s. 10(38), STT has still been continued.

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5.2 Further, there is no amendment in section 111A and hence short term capital gain shall be continued to be taxed at the rate of 15%.

5.3 In case of Foreign Institutional Investors (FIIs), a similar amendment is proposed to charge long term capital gain on specified capital asset at the rate of 10%. However, the proposed proviso only refers to income arising from transfer of a long term Capital Asset referred in Section 112A and it does not mention Long Term Capital Gains as computed u/s. 112A. Therefore, a doubt was raised as to whether the provision of Grandfathering of appreciation in price till 31st January, 2018 would apply to foreign institutional investors also. In FAQ dated 4th February, 2018 CBDT has clarified that the grandfathering provision will equally apply to FII's also. Hopefully with the passage of the Finance Bill, 2018, this situation will be taken care of by appropriate wordings in Section 115AD.

5.4 Further, the proposed amendment will not affect those FIIs which are from countries where the treaty provisions do not confer the right of taxation of capital gain to India. e.g. Netherlands.

Conclusion

In respect of LTCG on specified assets, the exemption provisions prevailing since last 14 years has been proposed to be removed and a new regime of taxation of such gains is proposed. How will these amendments impact the capital market will be an interesting thing to observe in the days to come. Further imposition of DDT on deemed dividend u/s. 2(22)(e) will be a major financial burden on closely held companies and may lead to a fresh set of litigation in this field. ■