



Short term capital losses which are subject to STT can be set off against Short term capital gains which are not subject to STT

Background

The Finance Act, 2004 introduced section 111A in the Income-tax Act, 1961 (the Act) prescribing a tax rate of 10 percent on Short Term Capital Gains (STCG) arising from sale of shares on or after 1 October 2004 on a stock exchange which are subject to Securities Transaction Tax (STT).

Before this amendment the STCG arising to non-residents (up to 30 September 2004) was taxable at the rate of 30 percent under the provision of section 115AD of the Act.

Recently, the Mumbai Income-tax Appellate Tribunal (the Tribunal) in the case of First State Investments (Hongkong) Ltd. (A/C First State Asia Innovation & Technology Fund¹) dealt with the issue of set off of Short Term Capital Loss (STCL) incurred from sale of shares on or after 1 October 2004 against STCG arose up to 30 September 2004. The Tribunal held that STCL (if gains then they are subject STT and to be taxed @ 10 percent) incurred on or after 1 October 2004 can be set off against the STCG (not subject to STT and to be taxed @ 30 percent) arose up to 30 September 2004.

Facts of the case

- The taxpayer was a non-resident and registered with SEBI as a sub-account of First State Investment (Hongkong) Limited, which was registered as Foreign Institutional Investor. During the year the taxpayer earned income from capital gains on sale of shares. At the time of calculating the amount taxable under the head capital gains,

¹ First State Investments (Hongkong) Ltd. [A/C First State Asia Innovation & Technology Fund] v. ADIT (2009-TIOL-547-ITAT-MUM)

the taxpayer set off STCL subject to STT first against STCG not subject to STT and offered the balance STCG to tax.

- However, the Assessing Officer (AO) contended that the taxpayer had wrongly set off the STCL subject to STT against the STCG not subject to STT with the object of reducing the incidence of tax payable on STCG. Accordingly, the AO rejected the taxpayer's calculation and calculated the net STCG after setting off against each category separately.

The computations prepared by the taxpayer and adjusted by the AO are given below:

Computation by taxpayer

STCG (up to 30 September 2004)	3,654,959
Less : STCL (up to 30 September 2004)	(814,966)
Less : STCL (on or after 1 October 2004) [16,923,874 – 14,083,881]	<u>(2,839,993)</u>
Total taxable STCG @ 30 percent	NIL
STT (on or after 1 October 2004)	47,216,333
Less : Balance STCL (on or after 1 October 2004)	(14,083,881)
Total taxable STCG @ 10 percent	33,132,452

Computation by AO

STCG (up to 30 September 2004)	3,654,959
Less: STCL (up to 30 September 2004)	<u>(814,966)</u>
Net short term capital gains taxable @ 30 percent	2,839,993
STCG (on or after 1 October 2004)	47,216,333
Less: STCL (on or after 1 October 2004)	<u>16,923,874</u>
Net short term capital gains taxable @ 10 percent	30,292,459

Taxpayer's contention

- As per section 70(2) of the Act, the taxpayer had a choice of setting off any STCL against any STCG from any other short term capital asset. The Act does not prescribe any order in which specific STCL should be set off against specific STCG.
- Further, the taxpayer relied on the decision of Special Bench of Mumbai Tribunal in the case of Montgomery Emerging Markets Fund² where it was held that in the absence of such description, the interpretation of the provision in favour of the taxpayer should be adopted.

² JCIT Vs. Montgomery Emerging Markets Fund [2006] 100 ITD 217 (Mum) (SB)

Tax department's contention

- The tax department contended that since there were two different provisions and tax rates for the transactions entered up to 30 September 2004 and on or after 1 October 2004 the taxpayer cannot set off the losses of lower rate against the gain of higher rate.

Tribunal's Ruling

- The words used in section 70(2) of the Act were that "the assessee shall be entitled" represents that the option lies with the taxpayer to decide the manner in which STCL from the first transaction will be set off against the STCG from any other transactions.
- If the intention of the legislature had been not to confer the choice on the taxpayer in the matter of setting off the STCG of the pre-cut-off date, it would have clearly set out such intention in the language of section 70(2) of the Act itself. In the absence of any stipulation in this regard the choice has been left over to the taxpayer in taking decision about the setting off of STCL from one transaction against any other STCG, whether within, or outside the cut-off date.
- If higher benefit is available from the exercise of the option in a particular way vis-à-vis the lower benefit resulting in the other way, then the higher benefit available as per law should not be denied. The Special Bench of the Tribunal in the case of Montgomery Emerging Market Fund has also ruled in favour of the taxpayer by holding that the set off of long term capital loss against the STCG was permissible under section 70 of the Act, in the period prior to the amendment.
- Sections 111A and 115AD of the Act falls in Chapter XII, which provides for determination of tax in certain special cases. Thus, it is clear that all these sections falling under chapter XII provide for a particular rate of tax to be applied on the incomes covered under these sections individually. Hence, these sections do not deal with the computation of income but only provide for the rate of tax applicable on the income.
- Accordingly, the Tribunal held that the taxpayer was allowed to set off STCL incurred on or after 1 October 2004 against the STCG arose up to 30 September 2004.

Our comments

- The Mumbai Tribunal has laid down a very important proposition that there is nothing in section 70, 71 to specifically prevent the STCL which are subject to STT being set off against STCG which are not subject to STT.

- This decision could be helpful for setting off losses in transactions subject to STT with the STCG not subject STT for off-market transactions like buy back, open offer, etc.
- It would be interesting to note that by relying on this decision whether it could be possible to contend that even in the case of long term capital loss (subject to STT) , a set off is possible against the long term capital gain arising from off-market transactions. It may be interesting to note that the XLS utility does not permit negative values (loss) being entered in the Schedule EI (Exempted Income) and only a positive capital gains could be stated there.

Disclaimer

The information contained herein is of a general nature and is not intended to address the circumstances of any particular individual or entity. Although we endeavour to provide accurate and timely information, there can be no guarantee that such information is accurate as of the date it is received or that it will continue to be accurate in the future. No one should act on such information without appropriate professional advice after a thorough examination of the particular situation.

For further information about KPMG in India and our services, please contact:

Bangalore

Maruthi Infotech Centre, 11-12/1
Inner Ring Road
Koramangala, Bangalore 560071
Phone: + 91 80 3980 6000 Fax: +91 80 3980 6999

Chennai

KPMG House
No.10, Mahatma Gandhi Road,
Nungambakkam High Road,
Chennai 600034
Phone: +91 44 39145000 Fax: +91 44 39145999

Delhi

DLF Cyber City, Building no. 10, Block B, Phase II
Gurgaon, Haryana 122 002
Phone: +91 124 307 4000 Fax: +91 124 254 9195

Hyderabad

KPMG, 8-2-618/2
Reliance Humsafar, 4th Floor
Road No.11, Banjara Hills
Hyderabad - 500 034

Phone: +91 40 30465000 Fax: + 91 40 30465299

Kolkata

KPMG Infinity Benchmark
Plot No. G-1, 10th floor Block - EP & GP,
Sector – V, Salt Lake City
Kolkata - 700091
Phone: +91 33 4403 4000 Fax: +91 33 4403 4199

Mumbai

KPMG House, Kamala Mills Compound, 448 Senapati Bapat Marg
Lower Parel, Mumbai 400 013
Phone: +91 22 39896000 Fax: + 91 22 39836000

Pune

703, 7th Floor Godrej Castlemaine, Next to Ruby Hall Clinic,
Bund Garden Road, Pune 411001
Phone: +91 20 30585764/65 Fax: +91 20 3058 5775

Kochi

4/F, Palal Towers, M. G. Road,
Ravipuram, Kochi 682016
Phone: +91 (484) 305 9000 Fax: +91 (484) 305 9001