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TAX FLASH NEWS

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CBDT issues press release and draft notification for exemption of acquisitions of equity shares from long-term capital gain tax

Background

Section 10(38) of the Income-tax Act, 1961 (the Act), prior to its amendment by the Finance Act, 2017, provided that the income arising by way of a transfer of long-term capital asset, being equity share in a company, shall be exempt from tax if such transfer is undertaken after 1 October 2004 and chargeable to Securities Transaction Tax (STT) under Chapter VII of the Finance (No. 2) Act, 2004.

In order to curb the practice of declaring unaccounted income as exempt long-term capital gain by entering into sham transactions, the Finance Act, 2017 amended the provisions of Section 10(38) of the Act to provide that exemption under this section for income arising on transfer of equity share acquired or on after 1 October 2004 shall be available only if the acquisition of share is chargeable to STT. However, to protect the exemption for genuine cases where the STT could not have been paid like acquisition of share in Initial Public Offer (IPO), follow-on public offer (FPO), bonus or rights issue by a listed company, acquisition by non-resident in accordance with Foreign Direct Investment (FDI) policy of the government, etc., it was provided that the central government shall notify the acquisition for which the condition of chargeability to STT shall not apply.

CBDT press release

Recently, the Central Board of Direct Taxes (CBDT) has issued a press release[1] proposing to issue draft notification under Section 10(38) of the Act. The proposed draft notification shall notify that the condition of chargeability to STT shall not apply to all transactions of acquisitions of equity shares entered into on or after 1 October 2004 other than the specified transactions.

CBDT draft notification

CBDT has issued draft notification[1] in exercise of the power conferred by the third proviso to Section 10(38) of the Act. In view of the said notification, the government for the purposes of the proviso to Section 10(38) of the Act, notifies all the transactions of acquisition of equity share entered into on or after 1 October 2004, which are not chargeable to STT under Chapter VII of the Finance (No. 2) Act, 2004, other than the following transactions:

- Where acquisition of listed equity share in a company, whose equity shares are not frequently traded in a recognised stock exchange of India, is made through a preferential issue other than those preferential issues to which the provisions of Chapter VII of the Securities and Exchange Board of India (Issue of Capital and Disclosure Requirements) Regulations, 2009 does not apply.

- Where transaction for the purchase of a listed equity share in a company is not entered through a recognised stock exchange.

- Acquisition of equity share of a company during the period beginning from the date on which the company is delisted from a recognised stock exchange and ending on the date on which the company is again listed on a recognised stock exchange in accordance with the Securities Contracts (Regulation) Act, 1956 read with Securities and Exchange Board of India Act, 1992 and any rules made there under.

[1] Source - www.incometaxindia.gov.in

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Comments/suggestions are invited from stakeholders on the draft notification by 11 April 2017[2].

Our comments

The draft notification is a welcome step, and it has addressed some of the concerns. However, some issues need to be clarified like the acquisition of shares by employees through trust under employee stock option plan, private equity investors or strategic investors, who generally purchase a large quantity of listed company shares outside the stock exchange, and could adversely impact the financial modeling and returns of such investors.

The draft notification, which lists down the negative list *inter alia*, covers transaction for the purchase of listed equity share in a company not entered through a recognised stock exchange. In this regard, the meaning of the term 'purchase' becomes relevant. For a transaction to be considered as a purchase, the existence of an asset at the time of the transaction (in this case listed equity shares) is imperative. The transaction of subscribing to the new shares of the company, bonus shares, etc. may be differentiated from a 'purchase' as these give rise to the creation of shares, which were not in existence earlier.

The Supreme Court in the case of Khoday Distilleries Ltd.[3] in the context of Gift Tax Act, 1958 held that the shares would come into existence only on the allotment. A share is a chose in action. A chose in action implies the existence of some person entitled to the rights in action in contradistinction from rights in possession. There is a difference between the issue of a share to a subscriber and the purchase of a share from an existing shareholder. The first case is that of creation whereas the second case is that of transfer of chose in action. Further, the Supreme Court in the case of Sri Gopal Jalan and Co.[4] observed that till the allotment, the shares do not exist, and it is only on an allotment that the shares come into existence.

The government has asked for comments / suggestions from the stakeholders by 11 April 2017. This will help the government to consider the representations made on genuine transactions, which may otherwise suffer an unintended consequence.

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[2] Comments/suggestions to be sent at the email address dirtpl2@nic.in
[3] Khoday Distilleries Ltd. [2009] 176 Taxman 142 (SC)
[4] Sri Gopal Jalan and Co. v. Calcutta Stock Exchange Association [(1963) 33 Com Cases 862] (SC)

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