Taxation of Shares and Securities and Applicability of Tax Audit

Workshop on direct taxes
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Topics

- Classification of income from taxation of securities (capital gains v business income)
- Treatment of income from shares and securities as capital gains:
  - Listed equity shares – long term v short term, rates of tax, method of calculation
  - Unlisted equity shares - long term v short term, rates of tax, method of calculation
  - Foreign securities - long term v short term, rates of tax, method of calculation
  - Other securities - long term v short term, rates of tax, method of calculation
  - Applicable tax audit disclosures
- Treatment of income from shares and securities as business income:
  - Listed equity shares
  - Unlisted equity shares
  - Futures and options including turnover calculation
  - Applicable tax audit disclosures

Classification of income from taxation of securities (capital gains v business income)

Classification of income from taxation of securities (capital gains v business income)

- Over years and acceptance of various propositions by CBDT – issue is more or less settled
- Separate portfolio of securities held as investments and securities held as stock in trade – possible (CBDT Circular No. 4 of 2007 dated 15.06.2007 (following Fidelity ruling – 288 ITR 641)
- Factors relevant for determining the classification of income from securities:
  - Intention of the assessee
  - Any memorandum or similar constitution of the assessee
  - Treatment of the securities by the assessee in books of accounts
  - Overall principal business of the assessee
  - Time devoted by the assessee for trading in securuties
  - Past conduct of the assessee
  - Period of holding of the securities
  - Number of trades and volumes
  - With respect to a particular scrip – frequency of trade
  - Funds utilised - Own v borrowed capital
  - Intra day and F&O trades – volume thereof
  - Whether the securities purchased or sold are listed or unlisted:
  - Whether investment is in sister/related concerns or independent companies and whether the transactions are by promoters

Classification of income from taxation of securities (capital gains v business income)

- CBDT Instruction No. 1827 of 31 August 1989
- CBDT Office Memorandum F. No. 149/287/2005-TPL dated 13 December 2005
- CBDT Circular No. 4 of 2007 dated 15 June 2007
- CBDT Circular No. 6 of 2016 dated 29 February 2016
  - Circular seeks to end certain controversies
  - If the assessee opts to offer income from listed shares as business income irrespective of holding – the income to be treated as business income
  - Listed shares and securities held for a period of more than 12 months – if declared as capital gains – position not to be disputed. However, the assessee needs to follow the practise consiatntly
  - For balance securities – position to be governed by earlier circulars/ clarifications
  - Circular held to have retrospective application – CIT v Century Playboard (I) Ltd. (148 taxmann.com 301)(Cal HC)
- CBDT letter dated 225/12/2016/ITA II dated 2 May 2016
  - Income from sale of unlisted securities to be considered as capital gains – irrespective of period of holding
  - Exceptions provided: (i) The genuineness of the transaction itself is questionable; (ii) the transfer of unlisted shares is related to issue pertaining lifting of corporate veil; (iii) The transfer of shares is made along with the control and management of underlying business
  - Implications on transfer of unlisted shares with control and management?
  - Non complete fee received by promoters alongwith transfer of shares?

Taxation of income from shares & securities as capital gains

Capital gains – listed equity shares and equity oriented MF (in India)

- Period of holding to qualify as long term assets – 12 months

- Long term capital gains:
  - Section 112A
  - Condition that STT should have been payable on sale and acquisition of shares – subject to certain exceptions
  - Tax rate @ 10%
  - Applicable to residents and non- residents alike
  - Applicable to listed equity shares and equity oriented MFs (including ULIP units where units meet criteria and do not qualify for exemption under section 10(10D)
  - No benefit under first and second proviso to section 48
  - Grandfathering of prices as on 31.01.2018
  - Cost of acquisition: Higher of: (A) Cost of acquisition or (B) Lower of (i) FMV as on 31.01.2018 and (ii) full value of consideration
  - No loss can arrive on account of grandfathering but can arise on account of cost of acquisition
  - No chapter VI-A deduction and rebate under section 87A
  - Unlisted shares getting listed subsequently – indexation may be permissible upto FY 2017-18
  - If not governed by 112A – governed by 112 – taxable @ 20% with indexation and 10% without indexation

Capital gains – listed equity shares and equity oriented MF

- Long term capital gains (contd…):
  - Bonus shares (peculiar calculation under different scenarios)

Particulars	Original shares	Bonus shares (1:1)
Date of acquisition	01.04.2016	15.02.2023
Cost of acquisition	1000	Nil
FMV as on 31.01.2018	1200	NA
Date of sale	11.08.2023	11.08.2023
Sale consideration (post bonus – otherwise 1500)	750	750
Capital gains/ (loss)	(250) Long term	750 Short term

Particulars	Original shares	Bonus shares (1:1)
Date of acquisition	01.04.2016	15.02.2023
Cost of acquisition	1000	Nil
FMV as on 31.01.2018	1100	NA
Date of sale	11.08.2023	11.08.2023
Sale consideration (post bonus – otherwise 2400)	1200	1200
Capital gains/ (loss)	100 (long term)	1200 (short term)

Capital gains – listed equity shares and equity oriented MF

- Short term capital gains:
  - Section 111A
  - Transaction should be subject to STT
  - Rate of tax 15%
  - Chapter VI-A deduction not allowable

Capital gains – listed securities in India (other than equity)

- Listed preference shares, bonds and debentures
- Period of holding to qualify as long term assets – 12 months

- Long term capital gains:
  - Section 112
  - Taxable @ 20% with indexation and 10% without indexation (except no indexation on bonds and debentures)
  - Taxation similar for both residents and non- residents

- Short term capital gains:
  - Regular tax provisions/ slab rates

Capital gains – shares (other than listed in India)

- Unlisted shares and shares of foreign company listed outside India or unlisted
- Period of holding to qualify as long term assets – 24 months

- Long term capital gains:
  - Section 112
  - Taxable @ 20% with indexation
  - In case of unlisted shares – held by non- resident – taxable @ 10% without benefit of proviso in case of capital gains
    - In case of loss arising to non- resident – whether benefit of first proviso available? – Legatum Ventures Limited (149 taxmann.com 436)(ITAT Mumbai)
  - Shares of foreign company – calculation of capital gains to be converted as per rule 115 – last day of the month immediately prior to the month in which asset is transferred
    - Benefit of indexation – whether leads to double benefit??

- Short term capital gains:
  - Regular tax provisions/ slab rates

Capital gains – others

- Unlisted bonds, debentures, MFs and ETFs (other than equity oriented mutual fund), other foreign securitiess
- Period of holding to qualify as long term assets – 36 months

- Long term capital gains:
  - Section 112
  - Taxable @ 20% with indexation (except for bonds and debentures where indexation benefit is not available)
  - Market Linked Debentures and debt mutual funds acquired on or after 01.04.2023 – deemed to be short term under section 50AA
  - Equity mutual funds of foreign companies not investing in domestic companies??
  - Foreign debt mutual funds – if less than 35% of total proceeds are invested in domestic companies – 50AA may apply? What is more than 35% of total proceeds are invested in domestic companies – 50AA may not apply?

- Short term capital gains:
  - Regular tax provisions/ slab rates

Other implications

- Implications under section 50CA
  - Fair market value to be full consideration if the consideration is less than fair market value
  - Rule 11UA – equity shares to be valued at net asset value - except immovable property to be valued at stamp duty.
  - Listed shares at quoted value
  - Other securities and shares – as per merchant banker valuation
- Section 56(2)(x)
  - Receipt of securities without consideration or for inadequate consideration
  - Fair market value over consideration taxable is income from other sources
  - Receipt of bonus shares and right shares – not taxable under section 56(2)(x)
    - Sudhir Menon (HUF) v ACIT (ITA No. 4887/Mum/2013)
    - ITO v Rajiv Ratanlal Tulsian (136 taxmann.com 42)(ITAT Mumbai)
  - Buy back of shares at a value lower than fair market value – shares brought back do not become property in the hands of the company buying back the shares
    - Vora Financial Services (P) Ltd. v ACIT (96 taxmann.com 88)(ITAT Mumbai)
  - Gift of shares to relatives – no liability for capital gains as well as 56(2)(x)
  - Gift of shares to non – relatives?
  - Gift of shares between corporates?

Other implications

- Section 56(2)(viib)
  - Receipt of aggregate consideration in excess of fair market value of the shares
  - Applicable only if the consideration exceeds the face value of shares
  - Value of shares to be determined by rule 11UA or such value as may be substantiated by the company to the satisfaction of the Assessing Officer, based on the value, on the date of issue of shares, of its assets, including intangible assets being goodwill, know-how, patents, copyrights, trademarks, licences, franchises or any other business or commercial rights of similar nature – whichever is higher
  - As per rule 11UA – value to be adopted as per book value or DCF
  - Justification of DCF – crucial in assessment proceedings
  - Post amendment by Finance Act 2023 – applicable for consideration for issue of shares received from resident and non-resident alike

Relevant tax audit disclosed

29. Whether during the previous year the assessee received any consideration for issue of shares which exceeds the fair market value of the shares as referred to in section 56(2)(viib), if yes, please furnish the details of the same. …………………….

29B. (a) Whether any amount is to be included as income chargeable under the head 'income from other sources' as referred to in clause (x) of sub-section (2) of section 56? (Yes/No) (b) If yes, please furnish the following details: (i) Nature of income : (ii) Amount (in Rs.) thereof :]

Taxation of income from shares & securities as business income

Important considerations

- Taxation of business income – ICDS I, ICDS II, ICDS VIII
- Applicability of tax audit – 44AB
- Presumptive taxation 44AD
- Speculative income under section 73

Taxation as business income

- ICDS VIII relating to Securities
  - Applicable only in respect of securities held as stock in trade
  - Applicable to securities as per SCRA and unlisted shares
  - Does not cover derivatives
  - Stock in trade to be recognised at cost or net realisable value – whichever is lower. Such valuation to be done category-wise (shares, debt securities, convertible securities and any other securities not covered above)
  - Unlisted securities to be at cost
  - FIFO or weighted average basis permitted
  - STT not to be separately included as deductible under section 36(1)(xv)
  - CBDT Circular No. 10 of 2017 dated 23 March 2017

    Question 19: Para 9 of ICDS-VIII on securities requires securities held as stock-in-trade shall be valued at actual cost initially recognised or net realisable value (NRV) at the end of that previous year, whichever is lower. Para 10 of Part-A of ICDS-VIII requires the said exercise to be carried out category wise. How the same shall be computed?

    Answer: For subsequent measurement of securities held as stock-intrade, the securities are first aggregated category wise. The aggregate cost and NRV of each category of security are compared and the lower of the two is to be taken as carrying value as per ICDS-VIII. This is illustrated below –

Taxation as business income

Security	Category	Cost	NRV	Lower of Cost or NRV	ICDS Value
A	Share	100	75	75	
B	Share	120	150	120	
C	Share	140	120	120	
D	Share	200	190	190	
	Total	560	**535**	505	**535**

E	Debt Security	150	160	150	
F	Debt Security	105	90	90	
G	Debt Security	125	135	125	
H	Debt Security	220	230	220	
	Total	**600**	615	585	**600**
		1160	1150	1090	**1135**

Taxation as business income

- ICDS II relating to Inventories
  - If derivatives not governed by ICDS VIII – what is the tax treatment?
  - CBDT Circular No. 10 of 2017 dated 23 March 2017

    Question 10: Which ICDS would govern derivative instruments?

    Answer: ICDS —VI (subject to para 3 of ICDS-VIII) provides guidance on accounting for derivative contracts such as forward contracts and other similar contracts. For derivatives, not within the scope of ICDS-VI, provisions of ICDS-I would apply.
  - ICAI Technical Guidance on ICDS VIII: *"3.7 This clarification seems to be not in accordance with the ICDS provisions. Derivative instruments, which are capital assets, would not be governed by ICDS at all."*
  - ICDS II scope:

    "This Income Computation and Disclosure Standard shall be applied for valuation of inventories, except :

    ……

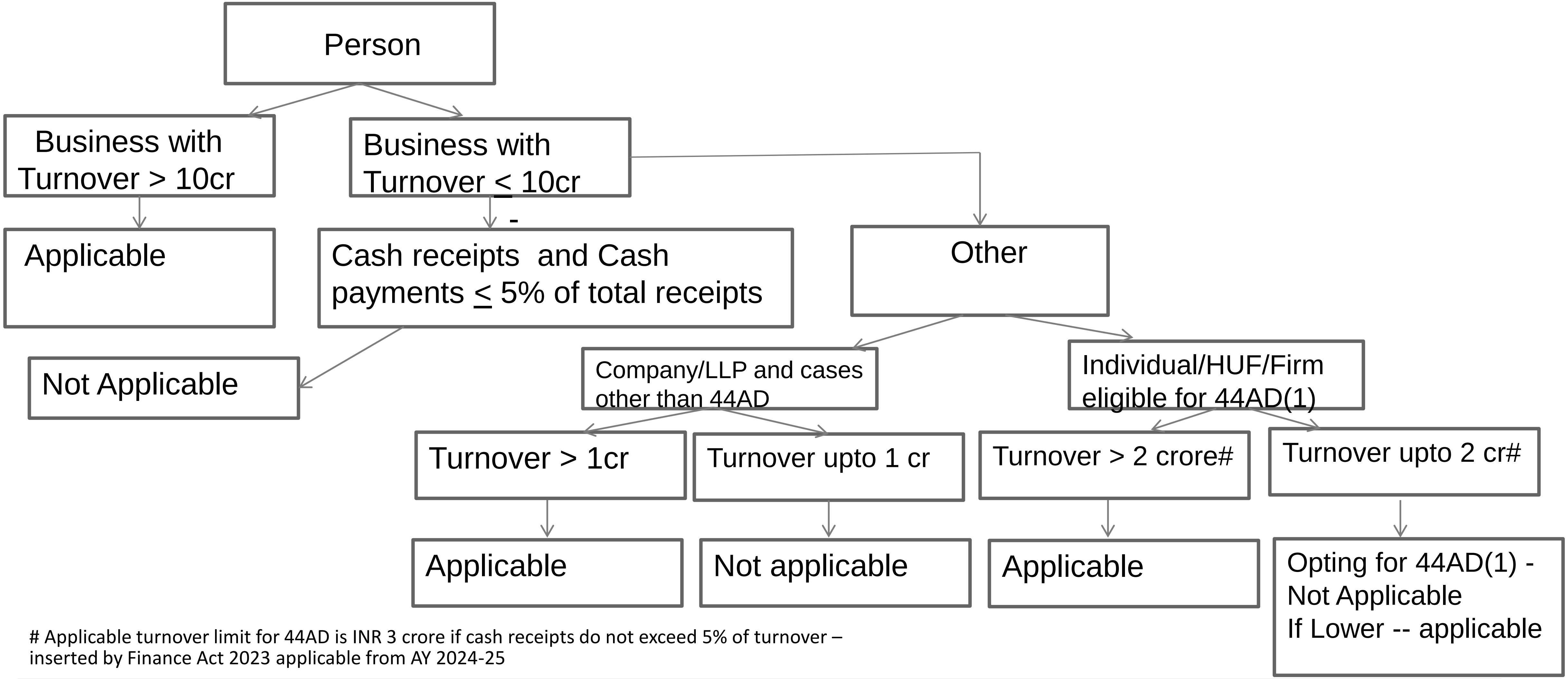
    (c) Shares, debentures and other financial instruments held as stock-in-trade which are dealt with by the Income Computation and Disclosure Standard on securities;

Taxation as business income

- ICDS II relating to Inventories
  - ICAI Technical Guidance on ICDS II:

    “2.4. As per para 3(1)(b) of ICDS VIII, the term `Securities’ shall have the meaning assigned to it in clause (h) of section 2 of the Securities Contracts (Regulation) Act, 1956, other than derivatives. Considering that the definition of securities contained in ICDS VIII specifically excludes derivatives, if an assessee holds derivatives as a part of his inventory, provisions of ICDS II shall apply. However, if the derivatives are not held as part of inventory, then such derivatives shall not be governed by the provisions of ICDS II. The definition of the term `Securities’ in para 3(1)(b) of ICDS VIII specifically includes share of a company in which public are not substantially interested. Accordingly, provisions of ICDS II shall not apply to shares of a company in which public are not substantially interested even if these are held as inventory.”
  - Valuation at cost or NRV whichever is lesser
  - FIFO or weighted average method
  - Para 19 of ICDS: 19. Inventories shall be written down to net realisable value on an item-by-item basis. Where ‘items of inventory' relating to the same product line having similar purposes or end uses and are produced and marketed in the same geographical area and cannot be practicably evaluated separately from other items in that product line, such inventories shall be grouped together and written down to net realisable value on an aggregate basis.
  - Also refer: Darashaw and Co. Pvt. Ltd. v JCIT (78 ITR 553)(ITAT Mumbai); DCIT Kotak Mahindra Investment Ltd. (59 SOT 4)(ITAT Mumbai)

Applicability of tax audit and turnover



Applicable turnover limit for 44AD is INR 3 crore if cash receipts do not exceed 5% of turnover – inserted by Finance Act 2023 applicable from AY 2024-25

Applicability of tax audit and turnover

- Taxpayers declaring profit in accordance with section 44AD(1) and sales/ turnover not exceeding INR 2 crore (second proviso to section 44AB) – no tax audit required under section 44AB
  - Eligible sssessee for section 44AD:
    - An individual, HUF, Firm (but not LLP) [Being Resident]
    - The assesse has not claimed deduction under section 10A, 10AA, 10B, 10BA or deduction under any provision of chapter VI-A – heading C
    - Is not carrying on any profession as defined under section 44AA(1)
    - Is not carrying on business of commission , brokerage or agency business
  - Eligible business for section 44AD
    - Is not carrying business as defined under section 44AE (running of trucks)
    - Turnover from the business is not above Rs 2 crore
- Applicability of proviso to clause (a) of section 44AB v first proviso to section 44AB? – turnover between 1 crore to 2 crore – conditions of less than cash sales and cash receipts are satisfied – but profit declared is less than 6%/8% whether tax audit is applicable?

Applicability of tax audit and turnover

- Section 44AD(4): If the person opts out of section 44AD and offers his income to tax under regular provisions at any time during 5 assessment years relevant to previous years immediately succeeding the previous year in which he has optioned for 44AD(1)- income cannot be declared as per presumptive provisions of 44AD(1) for a period of 5 years after the year of opting out
  - Whether tax audit mandatory if the income exceeds maximum amount not chargeable to tax – irrespective of turnover? Refer 44AB(e)
  - Example 1: Turnover for AY 2022-23 of INR 85,00,000/- Profit proposed to be declared @ 5% - INR 4,25,000 (also total income). Exemption claimed under section 44AD(1) for AY 2019-20, AY 2020-21 and AY 2021-22. Whether audit under section 44AB applicable? – Not applicable as per clause (a) <u>but applicable as per clause (e)</u>
  - Example 2: In above case – all facts remain the same – except for total income which is INR 2,25,000/- whether audit under section 44AB applicable? – Not applicable as per clause (a) or clause (e)
  - Example 3: Turnover for AY 2022-23 of INR 1,01,00,000/- Profit proposed to be declared @ 2% - INR 2,02,000 (also total income). Exemption claimed under section 44AD(1) for AY 2019-20, AY 2020-21 and AY 2021-22. Whether audit under section 44AB applicable? – Not applicable as per clause (e) <u>but applicable as per clause (a)</u>

Applicability of tax audit – calculation of turnover

Relevant guidance from ICAI GN on Tax Audit under section 44AB – draft released for AY 2023-24 is as under:

(a) Speculative transaction:

A speculative transaction means a transaction in which a contract for the purchase or sale of any commodity, including stocks and shares, is periodically or ultimately settled otherwise than by the actual delivery or transfer of the commodity or scrips. Thus, in a speculative transaction, the contract for sale or purchase which is entered into is not completed by giving or receiving delivery so as to result in the sale as per value of contract note. The contract is settled otherwise and squared up by paying out the difference which may be positive or negative. As such, in such transaction, the difference amount is 'turnover'. In the case of an assessee undertaking speculative transactions, there can be both positive and negative differences arising by settlement of various such contracts during the year. Each transaction resulting into whether a positive or negative difference is an independent transaction. Further, amount paid on account of negative difference is not related to the amount received on account of positive difference. In such transactions, though the contract notes are issued for full value of the purchased or sold asset, the entries in the books of account are made only for the differences. Accordingly, the aggregate of both positive and negative differences is to be considered as the turnover of such transactions for determining the liability to audit vide section 44AB.

Applicability of tax audit – calculation of turnover

Relevant guidance from ICAI GN on Tax Audit under section 44AB – draft released for AY 2023-24 is as under:

(b) Derivatives, futures and options:

Such transactions are completed without actual delivery of shares or securities or commodities etc. These are squared up by receipts/payments of differences. The contract notes are issued for the full value of the underlined shares or securities or commodities etc. purchased or sold but entries in the books of account are made only for the differences. The transactions may be squared up any time on or before the striking date. The buyer of the option pays the premia. The turnover in such types of transactions is to be determined as follows:

(i) The total of favourable and unfavourable differences shall be taken as turnover.

(ii) Premium received on sale of options is also to be included in turnover. However, where the premium received is included for determining net profit for transactions, the same should not be separately included

(iii) In respect of any reverse trades entered, the difference thereon, should also form part of the turnover.

(c) Delivery based transactions:

Where the transaction for the purchase or sale of any commodity including stocks and shares is delivery based whether intended or by default, the total value of the sales is to be considered as turnover.

Applicability of tax audit – calculation of turnover

Calculation of turnover on futures:

Sr.No.	Scrip	Units	Lots	Buying rate	Selling rate	Buying amount	Selling amount	Profit or (loss)	Turnover
1	NIFTY	100	100	16000	17000	16,00,00,000	17,00,00,000	1,00,00,000	1,00,00,000
2	Banknifty	200	100	17000	16,300	34,00,00,000	32,60,00,000	-1,40,00,000	1,40,00,000
								-40,00,000	**2,40,00,000**

Calculation of turnover on options:

Options	**Units**	**Buying Rate**	**Selling Rate**	**Difference**	**Premium Received**	**Turnover**
(A)	**(B)**	**(C)**	**(D)**	**[E= (B) x (D-C)]**	**(F= D x B)**	**(G)**
Nifty 18200 CE	100	300	210	Rs. - 9,000	Rs. 21000	Rs. 30,000
Tata Power 240 PE	500	45	70	Rs. 12,500	Rs. 35,000	Rs. 47,500
Bank Nifty 38500 CE	125	348	300	Rs. - 6,000	Rs. 37,500	Rs. 43,500
Total Turnover						**Rs. 1,21,000**

Applicability of tax audit – calculation of turnover

Calculation of turnover on options (held till expiry):

Sr.No.	Scrip	Strike price	Market price on expiry of option	Premium received	Profit/(Loss) on settlement by exchange	Net profit/ (loss)	Turnover
1	Call-short	15,000	15,900	500	-900	-400	400
2	Call-short	15,000	14,500	300	-	300	300
3	Put-Short	16,000	16,700	500	--	500	500
4	Put-Short	16,000	15,200	500	-800	-300	300
						100	1500

Sr.No.	Scrip	Strike price	Market price on expiry of option	Premium paid	Profit/(Loss) on settlement by exchange	Net profit/ (loss)	Turnover
1	Call-buy	15,000	16,200	-500	1,200	700	700
2	Call-buy	15,000	14,500	-500	--	-500	500
3	Put-buy	16,000	16,700	-500	--	-500	500
4	Put-buy	16,000	14,000	-500	2000	1500	1500
						1200	3200

Other points

- Applicability of higher turnover of INR 10 crore for F&O transactions
- F&O aggregation resulting in loss – turnover below INR 2 crore but more than INR 1 crore – tax audit mandatory
- Section 73 – limitations on set off
- Section 43(5) – Derivative transactions not speculative
- Intra day transactions – speculative
- Conversion of inventory into capital asset – 28(via) –
  - Whether cost is available as deduction?
  - Corresponding amendment in 49(9) and 2(42A).

Reference material

Meaning of securities

For the meaning of the term “securities”, Part A, Para 3(1)(b) of this ICDS refers to the definition provided under the Securities Contracts (Regulation) Act, 1956 (SCRA). The relevant definition under SCRA reads as under:

(h) “securities” include—

(i) shares, scrips, stocks, bonds, debentures, debenture stock or other marketable securities of a like nature in or of any incorporated company or other body corporate;

(ia) derivative;

(ib) units or any other instrument issued by any collective investment scheme to the investors in such schemes;

(ic) security receipt as defined in clause (zg) of section 2 of the Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002;

(id) units or any other such instrument issued to the investors under any mutual fund scheme;

Explanation. — For the removal of doubts, it is hereby declared that "securities" shall not include any unit linked insurance policy or scrips or any such instrument or unit, by whatever name called, which provides a combined benefit risk on the life of the persons and investment by such persons and issued by an insurer referred to in clause (9) of section 2 of the Insurance Act, 1938 (4 of 1938);

(ie) any certificate or instrument (by whatever name called), issued to an investor by any issuer being a special purpose distinct entity which possesses any debt or receivable, including mortgage debt, assigned to such entity, and acknowledging beneficial interest of such investor in such debt or receivable, including mortgage debt, as the case may be;

(ii) Government securities;

(iia) such other instruments as may be declared by the Central Government to be securities; and

(iii) rights or interest in securities;

CBDT Office Memorandum F No 149/287/2005-TPL dated 13 December 2005

“Circumstances to be considered by the Assessing Officers in determining whether a person is a trader or an investor in stocks:- (i) Whether the purchase and sale of securities was allied to his usual trade or business/was incidental to it or was an occasional independent activity: it means if it would be an occasional activity it is an unusual transaction and can be treated as investment and not as a business activity. (ii) Whether, the purchase is made solely with the intention of resale at a profit or for long-term appreciation and/or for earning dividends and interest.: it means if the purchase is for sales only then it would be business activity and if it would be for long term then it would definitely be investment. (iii) Whether scale of activity is substantial: means scale and quantum of activity is also an important factor; (iv) Whether transaction was entered into continuously and regularly during the assessment year: this is called recurrence of transactions. (v) Whether purchases are made out of own funds or borrowings: it may also be helpful because if an investor is making purchases from own funds it would most probably for the investment purpose though, it is not totally certain. (vi) The stated objects in the Memorandum and Articles of Association in the case of corporate assessee: In case of corporate assessee the object in the memorandum is also an important factor means if it’s a stock trading company then the income would be business income. (vii) Typical holding period for securities bought and sold: holding period is also a guiding factor. (viii) Ratio of sales to purchase and holding: It again indicates the quantum of transactions. (ix) The time devoted to the activity and the extent t o which it is the means of livelihood: it is a factor for judging as if a normal investor would not devote whole year in buying and selling only. (x) The characterization of securities in the books of account and balance sheet as stock-in-trade or investment: this is also a self explanatory point (xi) Whether the securities purchased or sold are listed or unlisted: this will help the assessing officer to a small extent but definitely more listed securities indicates the business activity. (xii) Whether investment is in sister/related concerns or independent companies: this can be a factor also. (xiii) Whether transaction is by promoters of the company: this will help in a way to judge whether promoters are investing in the company or not.. (xiv) total number of stock dealt in: it is again quantum (xv) whether money has been paid or received or whether these are only book entries: this is basically for assessing officer to judge the geniunity of transactions.

THANK YOU!