

Tax Hotline

April 27, 2018

CBDT NOTIFIES 10% TAX RATE FOR CERTAIN TRANSACTIONS

BACKGROUND

The most significant amendment to the Income Tax Act, 1961 ("ITA") introduced by the Finance Act, 2018 was the insertion of a provision imposing a long-term capital gains tax of 10%¹ on capital gains (exceeding INR 100,000 (approx. USD 1,500) arising on the transfer of listed equity shares or units of an equity oriented mutual fund.

The new provision, section 112A, came into effect on April 1, 2018. It was accompanied by the insertion of section 55(2)(ac) which provided for the value of gains earned up to January 31, 2018 to be grandfathered. A more detailed analysis of the new provision can be found in our 2018 Budget hotline available [here](#)².

Earlier, under section 10(38), long-term capital gains on listed equity shares and units of equity oriented mutual fund i.e., gains arising on the transfer of such shares and units held for a period of more than 12 months, were exempt from capital gains tax, provided that securities transaction tax ("STT") had been paid on the transfer of such shares / units.

Last year, the Finance Act, 2017 introduced an additional requirement for STT to be paid at the time of acquisition of listed shares in order avail of the section 10(38) exemption. However, the Central Board of Direct Taxes ("CBDT") exempted certain modes of acquisition from this requirement ("Section 10(38) Notification"). A detailed analysis on the list of transfers exempted from the payment of STT requirement can be found in our hotline available [here](#)³.

Section 112A also contains a similar requirement i.e., in the case of shares, to avail of the 10% rate STT must be paid at the time of acquisition and transfer⁴.

However, section 112A⁵ also left room for the Government to notify certain modes of acquisition of shares where the requirement to pay STT at the time of acquisition would not apply.

THE DRAFT NOTIFICATION

The CBDT has now issued a draft notification ("Draft Notification") specifying that the requirement to pay STT will not apply to (1) share acquisitions undertaken prior to October 1, 2004, (2) share acquisitions undertaken on or after October 1, 2004, subject to the following exceptions:

(a) An acquisition by way of a preferential allotment of shares that are not frequently traded⁶ in a recognised stock exchange of India except where:

- The acquisition has been approved by the Supreme Court, a High Court, the National Company Law Tribunal ("NCLT"), the Securities and Exchange Board of India ("SEBI") or the Reserve Bank of India ("RBI") in this behalf;
- The acquisition is by any non-resident in accordance with foreign direct investment guidelines issued by the Government of India;
- The acquisition is by a fund registered with the SEBI as a Category – 1 Alternate Investment Fund ("CAT-1 AIF"), a Category – 2 Alternate Investment Fund ("CAT-2 AIF") or a venture capital fund ("VCF"), or a Qualified Institutional Buyer ("QIB").⁷
- The acquisition is pursuant to a preferential issue to which the Chapter VII of the SEBI (ICDR) Regulations do not apply.⁸

(b) An acquisition through an off-market transaction, where listed shares are not acquired on the floor of the stock exchange, except where:

- the acquisition is by a scheduled bank, reconstruction or securitisation company or public financial institution during the ordinary course of business;
- the acquisition has been approved by the Supreme Court, a High Court, the NCLT, the SEBI or the RBI, in this behalf;
- the acquisition is under an employee stock option scheme or employee stock purchase scheme framed under the Securities and Exchange Board of India (Employee Stock Option Scheme and Employee Stock Purchase Scheme) Guidelines, 1999 ("ESOP Guidelines");
- the acquisition is by any non-resident in accordance with foreign direct investment guidelines of the Government of India;
- the acquisitions of shares of company is made under Securities and Exchange Board of India (Substantial

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- vi. the acquisition is from the Government;
- vii. the acquisition is by a SEBI registered CAT-1 AIF, CAT-2 AIF or VCF, or a QIB;
- viii. the acquisition is by mode of transfer not considered a transfer under sections 47 of the ITA or by way of a slump sale (as defined under section 50B of the ITA) if the previous owner of such shares acquired them pursuant to a mode of acquisition notified under the draft notification;

(c) An acquisition of de-listed shares: Listed shares acquired during a period between their de-listing and re-listing on the stock exchange.

ANALYSIS

The much anticipated release of the Draft Notification should provide some relief to foreign investors, especially since the 10% rate has been effective from April 1 of this year. Through this notification, the CBDT has simply extended the exemption list applicable to claim long term capital gains tax exemption that was introduced last year (with respect to section 10(38)), to the 10% beneficial rate under s. 112A. The exceptions under the two notifications are identical.

Similar to the Section 10(38) Notification, the Draft Notification provides for a double negative listing down transactions which would be caught under the Amendment and has then laid out exceptions to each one of them.

The exemption list is broad, and covers nearly all forms of foreign investors – including FDI investors and FPI Investors. Further, even off-market tax free transactions under s. 47 such as mergers, demergers and internal re-organizations involving listed shares have been given a blanket exemption.

Similarly, transactions which have been court approved have also been exempted as such transactions usually cannot involve payment of STT. An example would be a merger of listed companies which is a court approved process but does not involve paying of STT even though shares may be issued. Another example is the case of ESOPs. ESOPs are options given to certain key employees of the company to purchase or subscribe securities offered by the company (employer) at a pre-determined price at a future date and hence cannot be acquired on the floor of the stock exchange and therefore payment of STT is not possible. Further, granting ESOPs for listed companies is regulated by the SEBI.

While, the Government has attempted to address concerns of the business community by issuing the Draft Notification, other concerns regarding the applicability of s. 112A continue to remain, especially in terms of the grandfathering of gains made available for shares acquired prior to January 31, 2018. The Finance Act, 2018 provided that the grandfathering will not be available in (1) cases where shares were not listed as on January 31, 2018 but became listed as on the date of transfer, and (2) cases where listed shares were allotted in consideration for unlisted shares, and the allotment of shares happens after January 31, 2018. This is a concern as owing to the language of the limitations, demergers and mergers involving listed entities which have been approved by the SEBI and NCLT will seemingly be left out of the grandfathering benefit unless the listed shares have actually "become the property" of the shareholder prior to January 31, 2018. This is not consistent with the practical reality where court approved mergers taken substantial period of time to get approved and that should not be a ground for rejection of grandfathering benefit in cases where the scheme has been filed or approved by the appropriate regulators prior to January 31, 2018.

Another concern is that where convertible debentures of a listed entity have been issued pursuant to the relevant SEBI rules and regulations, and the conversion into listed shares is to happen at a later point in time, which is after January 31, 2018, the grandfathering benefit will not be available on the reading of the current language. The case of ESOPS issued prior to January 31, 2018 but exercised after January 31, 2018 is similar.

Another issue pertains to the tax rate applicable to the gains upto INR 1,00,000. In the case of a resident, it appears that the applicable rate will be 20%⁹ This appears to be an absurd situation, since it is inconceivable that a smaller investors should effectively pay a higher rate on long term capital gains. It is possible that the Government intended for gains upto INR 1,00,000 to be exempt. However, the unhappy wording of the provisions has placed small investors in a grossly unfair position.

A further issue relates wording of section 112A(4) read with section 112A(1)(iii)(a). It is unclear whether transactions referred to in the Draft Notification are intended to be exempt from payment of STT only at the time of transfer, or at the time of acquisition at well. Further clarity would be required to ensure certainty.

It is expected that the Government brings in more clarity and appropriate relief to affected players. The Government should ensure that past transaction that have been undertaken should not be affected due to the changes to the tax treatment. Providing clarity on this issue is well in line with the policy of the Government to not undertake any retrospective imposition of taxes, end "tax terrorism" and ensure that the taxpayer has certainty on his tax matters.

– Shipra Padhi & Joachim Saldanha

You can direct your queries or comments to the authors

¹ All rates are exclusive of applicable surcharge and cess.

² <http://www.nishithdesai.com/information/news-storage/news-details/article/india-budget-analysis-2018-19.html>

³ http://www.nishithdesai.com/information/research-and-articles/nda-hotline/nda-hotline-single-view/article/cbdt-notifies-transactions-which-can-avail-exemption-from-capital-gains-much-awaited-relief.html?no_cache=1&cHash=d44366b1864b868997fb5424a36acd7d

⁴ Section 112A(1)(iii)(a)

⁵ Sub-clause (4)

⁶ The notification defines "frequently traded shares" to mean shares of a company, in which the traded turnover on a recognised stock exchange during the twelve calendar months preceding the calendar month in which the acquisition and transfer is made, is at least 10% of the total number of shares of such class of the company, provided that where the share capital of a particular class of shares of the company is not identical throughout such period, the weighted average number of total shares of such class of the company shall represent the total number of shares.

⁷ A "Qualified Institutional Buyer" is defined under the SEBI (Issue of Capital and Disclosure Requirements) Regulations, 2009 ("SEBI (ICDR) Regulations") and includes: registered mutual funds, VCFs, AIFs, foreign venture capital investors ("FVCIs"), public financial institutions, schedule commercial banks, registered insurance companies, multilateral and bilateral development financial institutions,

state industrial development corporations, pension funds and provident funds with minimum corpus of INR 25 crores, the National Investment Fund, systemically important non-banking financial companies ("**NBFC-SI**") and insurance funds set up and managed by the Indian army, navy or air force or the Department of Posts.

⁸ Chapter VII of the SEBI (ICDR Regulations) sets out certain conditions pursuant to which a listed company may undertake a preferential allotment of shares. It does not apply where the preferential allotment is made (a) pursuant to conversion of a loan or option attached to a convertible debt instrument; (b) pursuant to a scheme approved by a High Court or the NCLT; (c) in terms of a rehabilitation scheme approved by the Board of Industrial and Financial Reconstruction ("**BIFR**") or a resolution plan approved by the Tribunal under the Bankruptcy and Insolvency Code, 2016.

⁹In the case of non-residents, it remains at 10%.

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