

Tax Wire



Penny wise, Pound foolish!

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adwith
CONSULTING

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Background

It has been constantly the effort of the Government to encourage the habit of savings and investment amongst its people and to ensure the surplus funds are not idle and are circulated in the economy. One of the measures that were adopted in this regard was simplification of taxation of shares traded in stock exchange. In 2004, the then government introduced Security transaction tax to be paid on purchase of securities through recognised stock exchange. Further, the exemption from capital gains long term shares was also introduced by way of section 10(38).

The Controversy

It was noticed by the revenue authorities that this exemption (benefit), however, was being misused by certain persons for declaring their unaccounted income as exempt long term capital gains by entering into sham transactions.

Amendment

In order to curb this malpractice, the Finance Act 2017 amended the provisions of the section to state that exemption shall be available only in case where the acquisition of such shares and units were also subject to STT. Recognizing the fact that there could be genuine transactions where the STT need not have been paid on acquisition of shares, the memorandum to the Finance Bill, 2017 while introducing the amendment had provided that such transactions to which the pre-condition of payment of STT on acquisition would not be applicable would be carved out by issuance of separate notification.

Notification u/s Sec. 10(38)

The notification, specifying the transactions on which the capital gain exemption will not be withdrawn in case

of non-payment of STT on the acquisition of the securities, was released by the CBDT vide Notification No. 43/2017 on 5th June, 2017.

The notification provides a negative list suggesting that for the transactions **other than the following specified transactions of acquisitions of equity shares, the condition of chargeability to STT would not be requisite for availing the exemption benefit** if those shares were acquired prior to :

- a. acquisition of existing 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**;
- b. acquisition of existing listed equity share in a company is **not entered through a recognised stock exchange** of India;
- c. 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 immediately preceding 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 (15 of 1992) and the rules made thereunder.

There are exceptions specified to each of the above clauses to ensure that any genuine transactions classifiable to be of the above nature are not affected by the said clauses.

Advith Comments

Known more popularly as the Penny Stock Scam that was unearthed in the year 2006 by the IT Department, it has been said to involve laundering of more than Rs.10,000 Crores of unaccounted

money through the scheme of trading in Microcap Stocks.

Investigations conducted of preferential allotment of shares by certain companies as per SEBI's orders revealed that the *Modus Operandi* of the fraudsters in the laundering of money was as under:

- The equity shares of the concerned company were listed on a particular Stock Exchange (SE). There is generally no trading history of such companies at the SE.
- The Company then makes a preferential allotment of certain number of equity shares at a low price to various individuals or group entities (preferential allottees).
- The equity shares allotted on preferential basis to the preferential allottees are locked-in for a period of one year in terms of Securities and Exchange Board of India (Issue of Capital and Disclosure Requirements) Regulations, 2009.
- The promoters and the preferential allottees then trade amongst themselves. There was no change in beneficial ownerships as the buyers and sellers were of the common group and were all in it together to provide long-term capital gains benefit to the preferential allottees.
- The prices of the shares were rigged and the common man was tricked into buying the shares of such shell companies at high prices by sending SMS to investing public as investing tips. In the influence of SMS tips, investors placed buy orders on the particular date at high price range resulting in purchase of shares from the preferential allottees (i.e. the sellers), resulting in very high capital gains to the preferential allottees which was **tax free**.

In the above process, the Company and preferential allottees used the securities market system to artificially increase volume and price of the scrip for making illegitimate gains and to convert illegal gains into genuine ones.

The revenue department recognising this laundering of money by the misuse of the provisions of Section 10(38) introduced the amendment to curb these practices. Exceptions such as the following have however been provided in order to ensure that the genuine transactions are not impeded:

- a. acquisitions approved by the Supreme Court, High Court, NCLT, SEBI or RBI;
- b. acquisition by any non-resident in accordance with foreign direct investment guidelines issued by the Government of India;
- c. acquisition by an investment fund referred to in clause (a) of Explanation 1 to section 115UB of the Income Tax Act or a venture capital fund referred to in clause (23FB) of section 10 of the Income-tax Act or a Qualified Institutional Buyer;
- d. acquisition under 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 and such other exceptions.

The government takes corrective steps when the loopholes in the law are identified and ensures that these are not used as devices to deceive the government of its revenue. The amendment to Section 10(38) is one such move to ensure that the laundering of money is avoided while also ensuring that the investors are not discouraged from carrying out genuine transactions.

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