

# Tax Hotline

June 14, 2017

## CBDT NOTIFIES TRANSACTIONS WHICH CAN AVAIL EXEMPTION FROM CAPITAL GAINS: MUCH AWAITED RELIEF!

- CBDT releases Final Notification in respect of section 10(38) of the Income Tax Act, which was amended by Finance Act 2017.
- Final Notification provides for transactions on which STT should have been paid at the time of acquisition, failing which exemption under section 10(38) will not be available.
- Final Notification takes into account representations and feedback from the industry in respect of the draft notification that was released earlier.

Section 10(38) of the Income Tax Act, 1961 ("**ITA**") was recently amended by the Finance Act, 2017 to limit the existing capital gains tax exemption to transactions where the acquisition of shares was chargeable to Securities Transaction Tax ("**STT**"). As per the amendment, the government was to provide a list of genuine transactions which would not be impacted by this change. Lack of clarity as to which transaction would continue to be exempt put various stakeholders in a limbo.

The Central Board of Direct Taxes ("**CBDT**") released a draft notification in respect of the amended Section 10 (38) for comments on April 3, 2017 and has now, after taking into account the feedback from the industry, issued a final notification providing for transactions on which STT should have been paid at the time of acquisition failing which the exemption under Section 10(38) will not be available ("**Final Notification**").<sup>1</sup>

### BACKGROUND

Section 10 (38) of the Indian Income Tax Act ("**ITA**") exempts from tax, long term capital gains ("**LTCG**") earned on transfer of listed equity shares provided that STT has been paid on the transaction of transfer. The Finance Act 2017 has, however, limited this tax exemption by adding a proviso to the Section which provides that in order to avail the exemption under it, in addition to STT having being paid on the transfer of shares, it should also have been paid at the time of acquisition of such shares ("**Amendment**").

The Amendment provides that the Government shall notify a list of transactions which would be exempt from the Amendment. In furtherance to this, the CBDT had released the draft notification inviting comments and suggestions from stakeholders. After having taken into account the suggestions/representations made by stakeholders, the CBDT has now released the Final Notification for the purposes of the Amendment.

### FINAL NOTIFICATION

As per the Amendment, the Government was supposed to notify a list of transactions that would enjoy the tax exemption on LTCG despite non-payment of STT at the time of acquisition. Contrary to this, the Final Notification provides that barring a few specific transactions, *all* transactions involving acquisition of listed equity shares on or after October 1, 2004, which are not chargeable to STT would continue to enjoy the tax exemption on LTCG. A number of exceptions to these specific transactions have also been provided in the Final Notification<sup>2</sup>.

The specific transactions (that come under the purview of the Amendment) along with the exceptions to them are set out below –

- Preferential Issue of shares*:<sup>3</sup> Acquisition of listed equity shares of a company whose shares are not frequently traded<sup>4</sup> in a recognized stock exchange of India.  
Exceptions:
  - Acquisitions which have been approved by the Supreme Court, High Court, National Company Law Tribunal, SEBI or Reserve Bank of India ("**RBI**").
  - Acquisitions by a non-resident in accordance with Foreign Direct Investment ("**FDI**") Guidelines issued by the Government of India.
  - Acquisitions by an investment fund referred to in clause (a) of Explanation 1 to section 115UB of the ITA or a venture capital fund referred to in clause (23FB) of section 10 of the ITA or a *Qualified Institutional Buyer*.<sup>5</sup> Amongst other things, this exception seeks to cover domestic investment funds such as Category I & II Alternate Investment Funds ("**AIFs**"), mutual funds, venture capital funds and foreign investors such as Category I & II Foreign Portfolio Investors ("**FPIs**"), Foreign Venture Capital Investors ("**FVCIs**") registered with SEBI.
  - Acquisitions through preferential issues to which the provisions of Chapter VII of ICDR Regulations do not

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apply. These include preferential issues (a) pursuant to conversion of loan or option attached to convertible debt instruments in accordance with the Companies Act, (b) pursuant to scheme of restructuring/arrangement approved by a tribunal or high court as per the provisions of the Companies Act.

- b. **Off-market acquisition of listed shares:** Listed equity shares not acquired on the floor of a recognized stock exchange
- Exceptions - :
- i. Acquisitions through an *issue* of shares by a company other than preferential issues covered in (a) above. Issue of shares involve issuance of new shares by a company. Amongst others, this seeks to cover acquisition of shares in an Initial Public Offering ("**IPO**"), Follow –on Public Offer ("**FPO**"), bonus issue, rights issues etc. (transactions where STT could not have been paid).
  - ii. Acquisitions by scheduled banks, reconstruction companies or securitisation companies or public financial institutions. For the purposes of this exception, 'scheduled bank' and 'public financial institution' shall have the meaning assigned to them in section 36(1)(vii) of the ITA. 'Reconstruction company' and 'securitisation company' shall have the meaning attached to them in Securities Contracts (Regulation) Act, 1956.
  - iii. Acquisitions which have been approved by the Supreme Court, High Courts, National Company Law Tribunal, SEBI or RBI.
  - iv. Acquisition under Employee Stock Option Scheme ("**ESOP Scheme**") and Employee Stock Purchase Scheme ("**ESP Scheme**") under SEBI (Employee Stock Option Scheme and Employee Stock Purchase Scheme) Guidelines, 1999 ("**ESOP Guidelines**").
  - v. Acquisition by any non-resident in accordance with FDI Guidelines of the government of India.
  - vi. Acquisition of shares of a company under SEBI (Substantial Acquisition of Shares and Takeovers) Regulations, 2011 ("**Takeover Regulations**").
  - vii. Acquisition of listed equity shares held by the Government.
  - viii. Acquisitions by certain kinds of domestic and international investment funds including Cat I & II AIFs and FPIs. Please see exception (iii) to (a) above.
  - ix. Acquisition by mode of transfer referred to in section 47 or 50B of the ITA provided the previous owners did not acquire the shares by way of transactions in (a) above or (c) below. Amongst other things, this exception seeks to cover transfers by way of amalgamation between parent and subsidiary and vice versa, amalgamation between Indian companies, amalgamations between foreign companies with underlying Indian assets, transfers by way of gift, demergers, conversion of preference shares into equity shares of a company, slump sale etc.
- c. **Acquisition of de-listed shares:** Listed shares acquired during a period between their de-listing and re-listing on the stock exchange.

## ANALYSIS

Considering that in recent past, SEBI has taken effective action in respect of more than 200 shell companies which have been used to take benefit of Section 10(38), the need to limit the provision had definitely arisen. However, the method by which the Ministry has tried to find a solution for the issue may not prove to be ideal. In fact, the release of a draft notification which did not take into account how genuine stakeholders may be impacted gives the view that the CBDT was not fully clear on how to mitigate the issue at the time of proposing the Amendment to the ITA. Further, even though the approach that ought to have been adopted by the Government was to specify all transactions not caught within the Amendment, the 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. Such drafting can result in confusion to readers.

Having said that, CBDT has made a commendable effort by taking into account representations of the stakeholders and then coming out with a Final Notification which provides for various carve outs and exceptions which were not present in the draft notification. While there is a specific carve out for foreign direct investors (FDI), the carve out for other foreign investors such as FPIs, FVCIs etc. is more implicit. However, since the intent seems to cover almost all foreign investors, the exemptions come as a huge relief, as foreign investors tend to acquire listed shares off the market in a variety of genuine transactions. For instance, foreign investors making FDI investments in listed companies and acquiring 10% or more stake have to undertake an off-market purchase which by its very nature cannot be subject to STT. Similarly, FPIs may acquire listed equity shares by way of allotment of shares in situations such as mergers, ESOPS, rights issue, bonus issue etc. which cannot take place on the floor of the stock exchange and hence STT cannot be paid on such transactions. Further, foreign investors are heavily regulated and their investments undergo substantial scrutiny and hence the chance of them to be considered as sham /non-genuine are fairly low. In that sense, it is a welcome move that that such situations have been specifically provided relief from the applicability of the Amendment and thereby allowed to take benefit of Section 10(38).

Similarly, transactions which have been court approved also do not fall within the ambit of the Amendment as such transactions usually cannot involve payment of STT but should not result in the taxpayer not being able to take benefit of the exemption available to it. 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. Same is the case with 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.

Seeing the exceptions provided to the list of transaction on which STT should have been paid, the intent of CBDT seems that transactions which are regulated by regulatory authorities such as SEBI, RBI should not fall within the ambit of the Amendment and hence should be allowed to take benefit of the exemption under Section 10(38). However, no relief has been provided to CAT III FPIs. Considering that the Amendment was introduced to prevent situations where people have abused the law and carried out non-genuine transactions, CAT III FPIs being regulated should have been included in the exceptions list. Another integral exception not specifically carved out is a situation when an unlisted company lists its shares. However, considering that all transactions of acquisition of equity shares

except the ones listed in the Final Notification are considered to be outside the purview of the Amendment, acquisition of equity shares of an unlisted companies should also fall there and the LTCG exemption under Section 10(38) should be available.

– Afaan Arshad & Ashish Sodhani

You can direct your queries or comments to the authors

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<sup>1</sup> See [http://www.nishithdesai.com/fileadmin/user\\_upload/pdfs/notification43\\_2017.pdf](http://www.nishithdesai.com/fileadmin/user_upload/pdfs/notification43_2017.pdf)

<sup>2</sup> It is important to note that the Draft Notification had outlined three categories of transactions which would come under the purview of the Amendment i.e. transactions which would not be eligible for LTCG exemptions. Due to the general nature of two out of the three categories of transactions, a lot of genuine transactions were still likely to get caught in the net. However, the Final Notification provides exceptions to those two categories of transactions to ensure that genuine transactions are not caught under the Amendment.

<sup>3</sup> Preferential Issue has been defined in the Securities and Exchange Board of India ("SEBI") (Issue of Capital and Disclosure Requirements) Regulations 2009 ("ICDR Regulations") to mean –

*“an issue of specified securities by a listed issuer to any select person or group of persons on a private placement basis and does not include an offer of specified securities made through a public issue, rights issue, bonus issue, employee stock option scheme, employee stock purchase scheme or qualified institutions placement or an issue of sweat equity shares or depository receipts issued in a country outside India or foreign securities.”*

<sup>4</sup> As per the Final Notification, *‘frequently traded shares means 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 ten percent of the total number of shares of such class.*

<sup>5</sup> As per the Final Notification, *‘qualified institutional buyer’ means: (i) a mutual fund, venture capital fund, Category I and II Alternative Investment Funds and foreign venture capital investor registered with the Board; (ii) a foreign portfolio investor other than Category III foreign portfolio investor registered with the Board; (iii) a public financial institution as defined in section 4A of the Companies Act, 1956; (iv) a scheduled commercial bank; (v) a multilateral and bilateral development financial institution; (vi) a state industrial development corporation; (vii) an insurance company registered with the Insurance Regulatory and Development Authority; (viii) a provident fund with minimum corpus of twenty five crore rupees; (ix) a pension fund with minimum corpus of twenty five crore rupees; (x) National Investment Fund set up by resolution no. F. No. 2/3/2005-DDII dated November 23, 2005 of the Government of India published in the Gazette of India; (xi) insurance funds set up and managed by army, navy or air force of the Union of India; (xii) insurance funds set up and managed by the Department of Posts, India.*

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