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FURTHER EXEMPTIONS ON LONG TERM CAPITAL GAINS IN INDIA

Background

Under the existing provisions of section 10(38) of the Income-tax Act, 1961 (the "**IT Act**"), income arising from the transfer of a long term capital asset, being equity shares of a listed company or units of an equity oriented fund, is exempt from capital gains tax if the sale transaction is chargeable to Securities Transaction Tax (" **STT**") under Chapter VII of the Finance (No.2) Act, 2004 (the "**Tax Exemption**").

As per press reports, the Tax Exemption was being misused by stock market operators who converted unaccounted income into legitimate tender by entering into sham share purchase transactions in illiquid or penny stock companies.

To curb this malpractice, section 10(38) of the IT Act was amended by the Finance Act, 2017, and the Tax Exemption is now available only on transfers of listed equity shares on which STT has been paid at the time of acquisition. However, in order not to impact genuine share transfers, it has been provided that transactions where the STT could not have been paid, (as for example, in an acquisition of shares in an IPO, on the issuance of bonus or rights shares by a listed company and on an acquisition of shares by a non-resident in accordance with India's foreign direct investment policy (the "**FDI Policy**"), would be carved out by issuance of a separate notification. The Central Board of Direct Taxes has issued a notification number 1789 dated June 5, 2017 (the " **Notification**"), which will be codified into section 10(38) of the IT Act.

This update discusses the salient features of the Notification.

The Notification

The Notification provides for the following three (3) negative lists and carve outs applicable to each.

- The Tax Exemption will not be available in an acquisition by way of a preferential allotment of listed equity shares not frequently traded on a recognized Indian stock exchange, except if the acquisition through a preferential allotment:

- has been approved by India's Supreme Court, a High Court, the National Company Law Tribunal (the "**NCLT**"), the Securities Exchange Board of India (the "**SEBI**") or the Reserve Bank of India (the "**RBI**");

- is by a non-resident in accordance with India's FDI Policy;

- is by a SEBI-registered investment fund or a specified venture capital fund registered under the IT Act, or by a Qualified Institutional Buyer (" **QIB**"); or

- is done under the provisions of Chapter VII of the SEBI (Issue of Capital and Disclosure Requirements) Regulations, 2009, and the guidelines relating to pricing in public offerings, conditions

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governing promoter's contribution, restriction on transferability of promoter's contribution, minimum offer to public, reservations, manner of disclosures in offer documents, etc. are followed.

- The Tax Exemption will not be available in case of an acquisition of listed equity shares not routed through a recognized Indian stock exchange, except if the acquisition of listed shares is (in accordance with the provisions of Securities Contract (Regulations) Act, 1956 (as applicable)):

- by scheduled banks, reconstruction or securitization companies, or public financial institutions during the ordinary course of their business;

- approved by India's Supreme Court, a High Court, the NCLT, the SEBI or the RBI;

- under an employee stock option scheme or an employee stock purchase scheme framed under the SEBI (Employee Stock Option Scheme and Employee Stock Purchase Scheme) Guidelines, 1999;

- by a non-resident in accordance with India's FDI Policy;

- under the SEBI (Substantial Acquisitions of Shares and Takeovers) Regulations, 2011;

- such that shares are acquired from the Indian government;

- by a SEBI-registered investment fund or a specified venture capital fund registered under the IT Act, or by a QIB; or

- a transfer referred to in sections 47 or 50B of the IT Act, and the previous owner of such shares has acquired them through the carve outs listed in points 1 and 2 above. Section 47 of the IT Act *inter alia* includes: (a) transfer by way of a gift or will or an irrevocable trust; (b) transfers by a holding company to its wholly owned subsidiary and *vice versa*; (c) transfer in a scheme of amalgamation; (d) transfer in the case of demergers; and (e) specified business reorganizations and corporatizations; and Section 50B of the IT Act deals with computation of capital gains tax in the case of a slump sale.)

- The Tax Exemption will not be available in case of acquisition of equity shares of a company during the period beginning from the date on which the company is delisted from a recognized stock exchange and ending on the date immediately preceding the date on which the company is again listed on a recognized stock exchange in accordance with the Securities Contracts (Regulation) Act, 1956 read with the Securities and Exchange Board of India Act, 1992 and the rules made there under. No special carve outs have been provided here.

This Notification is applicable with effect from April 1, 2017.

Comments

The Notification maintains a balance between curbing the abuse of the Tax Exemption and ensuring the protection of *bona fide* transactions.

While the Notification is welcome for its *pro active* approach, unintended hardship may be experienced in certain cases (as for example, (i) if the acquisition is during the period after the shares of the company are delisted irrespective of the reasons for delisting, or (ii) when an acquisition has been made outside the stock exchange but as a result of events such as liquidation, contribution of shares to a partnership firm, dissolution of a partnership firm; etc.) Further, the Tax Exemption availability criteria will be of significant relevance to strategic investors or foreign portfolio investors investing into India out of Mauritius, Singapore or Cyprus, particularly after the amendments to their respective double taxation avoidance agreements with India.

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