Re-imagining Taxes on Capital Market Transaction in India

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A. Introduction

With an increase in domestic and cross-border transactions and the rising dominance of the digital market, the changes in the capital market environment are evolving. Changes are visible in every aspect, i.e., the players, structures, means, volume and accessibility. Companies are shifting means for raising capital, from the traditional format of issuing shares to flexible alternatives that permit them to expand their reach across various classes of investors. As an outcome of digitalisation and liberal exchange control, the Indian capital market has become more accessible. It's no longer an avenue restricted to a limited class of large investors. Instead, it is witnessing the advent of a new investor class. Thus, there is an impelling need to re-evaluate the efficiency and effectiveness of existing tax policy and the law governing capital market transactions in India.

B. Overview of taxes related to Capital Markets

1. Direct Taxes

a. Capital Gains – Gains on the trade of listed shares and units of equity-oriented funds in the capital market attract capital gains tax, and the tax rate is determined based on the holding period of such security. A 15% is applicable to Short-term Capital Gain (STCG), i.e., when the holding is less than 12 months and 10% for Long-term Capital Gains (LTCG) when the holding exceeds 12 months. The same tax rate applies to domestic and foreign portfolio investors (FPIs), though the latter enjoy beneficial tax rates depending on the application of the relevant treaty.

There has been a long-lasting dispute concerning the characterisation of income from the sale of shares and securities as business income or capital gains. Most countries merge the STCG, subjecting such gains to the regular tax rate. However, in India, capital gains from the transfer of securities have to be characterised for which the CBDT has issued a circular[1] that broadly prescribes certain tests such as period-of-holding, underlying intention and accounting treatment, etc.

b. Securities Transaction Tax (STT) – STT was introduced into the law in 2004 as a substitution for exempting LTCG on listed securities and is levied at the following rates:

Types of Taxable Securities	Rate of STT on sale (in per cent)
Delivery-based equity shares	0.125
Equity-oriented mutual funds	0.25
Derivative – sale of options or futures	0.17

Though STT was introduced to replace the tax on LTCG, it continued to apply even after the reintroduction of the tax on LTCG. Therefore, both the levies are currently applicable.

c. Tax on dividends – From April 01, 2020, the dividends received from an Indian company are taxable in the hands of the shareholder. Until March 30, 2020, dividends were exempt, and Dividend Distribution Tax (DDT) was levied[2] on the payer company. The 2020 law shifted the tax burden on the investor who is taxed as per the applicable tax rates. Companies must deduct tax at 10% if the amount exceeds Rs. 5,000. Currently, if the income arises from trading activities, it is characterised as business income. Whereas if shares are held as an investment, they are characterised as income from other sources. If a domestic company receives the dividend, the same is permitted as a deduction.[3]

d. Withholding Tax (WHT) – Tax withholding is a means for the Revenue department to keep track of transactions. However, in the case of Indian residents, the withholding provisions find a place in the law only for dividends and not on income arising on a sale, i.e., capital gains. In the absence of a one-to-one contract between the buyers and sellers in an on-market transaction, the Revenue department clarified that these transactions are kept out of the withholding mechanism recently introduced on goods[4].

2. International Tax Implications

a. Capital Gains – India generally leans towards source-based taxation; hence, dividends and capital gains from Indian companies are taxable. Treaties like Singapore and Mauritius historically permitted taxation of capital gains in residence jurisdiction which were amended to shift the right to the source nation. Therefore, an investor selling their shares or securities in an Indian company is subject to the capital gains tax under the Indian tax law. The debate on the characterisation as capital gains or business income becomes relevant here as well, and the 2016 Circular[5] is significant for inbound investors. Specifically, the law was amended in 2015 to include securities held by FPIs within the definition of a capital asset.[6]

b. Dividends– Certain investment institutions, such as FPIs, are taxable on dividends they receive on their investors' behalf. On the other hand, investment trusts such as REITs and InvITs are not taxed for dividends received due to pass-through status, i.e., the investors/unit holders are instead subject to tax.[7] The dividend income, in the hands of a non-resident person (including FPIs and non-resident Indian citizens (NRIs)), is taxable at the rate of 20%. This rate may differ based on the application of relevant treaty provisions (the rate varies from 5% to 20% depending on the treaty).

c. Transactions with International Financial Service Centre (IFSC)-
The IFSC was introduced through the Finance Act of 2015 with a vision to become a global financial and IT services hub by inviting offshore and domestic banks, capital market participants and insurance players. In pursuance of this, several incentives, including tax incentives, were offered to units in IFSC as well as non-resident investors operating through such IFSC units. Amongst other benefits, it includes a concessional tax on capital gains (10% for LTCG and 15% for STCG) derived from the sale of equity shares/units of equity-oriented funds/units of business trust on a recognised stock exchange in IFSC and received in foreign exchange.[8] It also provides tax exemption for income arising from the transfer of ODI and OTC derivatives entered into with Offshore Banking Unit located in IFSC.

C.The Changing Landscape and Need for Re-examination

1.Special Purpose Acquisition Companies (SPACs) – A SPAC has emerged as an avenue for raising capital with an objective of acquiring a target(s). When raising funds through an IPO, a SPAC has no underlying assets; therefore, it's a shell company backed by reputed sponsors. Once a target is identified and acquired, the shareholders (of SPAC) are given shares in the acquired company. Hence, the shareholders cannot monetise their investments until a target is identified and acquired. The law has stringent provisions on the usage of shell companies, which are viewed as vehicles for tax evasion. Besides, the law has anti-avoidance provisions prohibiting transfers that lack commercial substance.[9] Considering SPACs do not have any underlying assets and targets are usually not identified until the end of the IPO, such investment structures are not feasible under the Indian framework. Further, where an overseas SPAC acquires an Indian target, it is considered taxable event and subject to capital gains tax in the hands of the Indian target and its shareholders. India needs to develop an enabling framework for SPAC investments.

2.Impact Investment – Investments directed towards enterprises focused on social benefits are termed as impact investments. Investment structures under India's regulating framework do not cover such Social Venture Funds (SVFs) and are characterised as Alternate Investment Funds (AIFs). The regulatory framework identifies not-for-profit SVFs and equates (for-profit) SVFs to usual AIFs despite their focus on social welfare. It follows that the tax rates applicable to SVFs are like any other funds, i.e., the investors of SVF are subject to capital gains tax of 10% in case of LTCG and 15% in case of STCG. There are no special incentives encouraging investment in such funds. The UK has Social Investment Tax Relief that provides benefits to the investors, including a 30 per cent deduction in the value of investments, deference for related capital gain and relief from capital gains tax during disposal of the investment.

3.Shares of Private Companies and Anti-avoidance Tools - The specific anti-avoidance provisions[10] in case of issue and transfer of shares of private companies are extensively worded and cast a heavy burden on the shoulders of the taxpayers. As per the current judicial guidelines[11], the burden of proof is high on the company issuing shares that the amount of share capital originates from genuine investors. Further, this burden is deemed not to be discharged unless the investor also explains the source of funds invested in the company. Several amendments have been made to carve out a class of investors such as venture capitalists, etc.; however, the law is daunting and discourages genuine investors. A review of these provisions is the current need to prevent unintended tax controversy and encourage genuine investments.

4. Retail Investors – Maturity in the capital market is experiencing a shift from Institutional investors to retail investors and a new class of investors such as REITs, InvITs and AIFs. The share of retail investors in listed NSE companies

is nearing the share of domestic mutual funds with 7.42% and 7.75%, respectively.[12] Considering the increasing importance of retail investors, the tax relating to capital markets must also advance to the ease and interest of investors. The current structure is complex and least investor friendly. For instance, the LTCG tax rate at 10% on listed equity shares above INR 1 lakh should be reviewed. LTCG was reintroduced in 2018 to disrupt corporates and LLPs from benefiting due to exemptions. Given the rise in retail investments, there is a need to review the rate.

D.Way Forward

For the economy's growth, the investment environment must be equipped to accommodate the diversity and innovation that is renovating the investment space. The usage of SPAC affirms a shift towards innovative forms of investment structures. Impact investment reimagines the role of corporates in society. And finally, retail investors have redefined the understanding of investor class.

Despite the growth, the country's tax law is yet to catch up. This must occur soon as any delay will only impact the investors and the market growth. A simple and accessible tax policy will help retain and attract investors. It is time to accept that the investment environment has been reimagined and transformed, highlighting the need for the tax policy to witness the same.

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1 CBDT Circular No. 06 of 2016 dated 29 February 2016
2 Introduced by the Finance Act of 1997
3 Section 80M of the Income-tax Act, 1961 ('the Act')
4 Section 194Q of the Act
5 CBDT Circular No. 06 of 2016 dated 29 February 2016
6 Section 10(14) of the Act.
7 Section 115UA of the Act
8 Section 111A and 112A of the Act
9 Section 95 of the Act
10 Sections 56 and 68 of the Act
11 PCIT v. NRA Iron & Steel (P.) Ltd. [2019] 412 ITR 161 (SC) affirmed in [2020] 273 Taxman 14 (SC)
12 ICICI, Retail Investors Ruling the Indian Stock Market, Available at: https://www.icicidirect.com/research/equity/weekend-readings/retail-investors-ruling-the-indian-stock-market