

Taxman's trap, woven around a name game

THE issue of taxation of the gains arising from investing in the stock market has been at the centre of attention for several years now. The issue is very important as a shift from one category to the other can make a huge difference in terms of the tax to be paid. The classification of the income of FIIs has been mentioned as a reason for the rise and fall in the markets on quite a few times in the past. Confusion about a draft Central Board of Direct Taxes (CBDT) circular is said to be one of the reasons for Thursday's market meltdown.

ET demystifies the confusion over taxing FIIs. First some basics. When a person is considered to be an investor in stocks, then the gains made from the investment fall under the head of capital gains and there is a concessional rate of tax applicable for transactions conducted through the stock exchange. The short-term capital gains rate in such a situation is at 10% and the long-term capital gain is tax-free.

On the other hand, if a person is considered to be a trader, then the entire income will be considered as income from business and the net income would be taxed at the applicable corporate tax rate for the specific entity. This means that the figure could go up to 40% plus surcharge and cess for foreign companies. The way in which the assessing officer classifies the entity is important and hence various market participants look at the instructions on this issue very closely.

The CBDT proposes to issue additional instructions on this subject but the first important point that one has to note is that they have not been issued as yet and before issuing them the CBDT has invited comments of all stakeholders by May 25, '06. This means that these are not final instructions yet. The draft released by the CBDT mentions that whether a person is a trader or an investor depends on factors such as whether the purchase is made "solely" with the intention of resale at a profit or for long-term appreciation and/or earning dividend and interest, whether scale of activity is substantial, whether purchases are made out of own funds or borrowings, the typical holding period for securities bought and sold, the time devoted to the activity and the extent to which it is the means of livelihood. These points should be considered in determining the nature of the taxpayer, according to the draft. Another important aspect mentioned in the proposed guidelines is that the assessing officers have been advised that no single criteria listed there is decisive and the total effect of all these measures should be considered to determine the nature of activity. Tax experts say that CBDT's instructions should prescribe a weightage to the 15 criteria so that the assessing officer can make a determination more objectively.

The worry among certain sections of the market is that if these are applied to hedge funds and other FIIs, then they will be classified as traders and hence would not be able to enjoy the benefits of the concessional rate of tax. However, tax experts have a different opinion: "The CBDT's draft instructions may not have a significant impact on foreign investors as most of them have been investing through Mauritius or have treaty protection. However, it is likely to impact domestic investors such as pensioners who are trading regularly and have so far been paying a concessional 10% short-term capital gains tax. With these instructions, it is more likely that their income would be treated as business income subjecting it to a 33% tax rate," according to Bijal Ajinkya, senior associate, Nishith Desai Associates.

"The CBDT's draft instructions are general in nature and not directed to a specific class of investors. Most FIIs already have treaty protection. So, they will not be impacted and, in fact, will be better off if the gains from investment in securities is classified as business profits," says Hiresh Wadhvani, tax partner, E&Y. Chartered accountants say that a closer look at the various points mentioned there shows that these are not new, but have been collected from various Supreme Court and high court judgements, when several of these points have been highlighted.

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