

Capital gains or business income?

Ambiguity, and not the levy, hurts

THE CBDT has proposed to issue supplementary instructions listing criteria to be considered by assessing officers (AOs) in determining whether an assessee is a 'trader' in stocks or an 'investor' therein. This determination will decide whether an assessee pays tax at the lower rates applicable on capital gains income or whether an assessee pays tax at the higher rate applicable to business income.

While the draft instructions indeed seek to reiterate the principles laid down by tax cases in the past, it is well accepted that this determination is no simple task and leaves much to discretion and judgement. For the assessee, at times, it is this ambiguity rather than the actual levy that hurts. With the FM intervening to clarify that FIIs are 'investors' and would not be hit by these instructions, and with domestic mutual funds being tax-exempt in any case, it is the domestic individual and corporate assessee who are most likely to bear the brunt of this ambiguity.

With simplicity being one of the accepted hallmarks of a good tax system, tax administrators could look at applying a simple and definitive criteria to make such determination, at least insofar as it relates to the vast expected majority of such determination cases, viz., transacting in listed shares. One such criteria could be the period of holding, with the present one year holding period being taken as the cut-off for long-term capital gains, and a much shorter acceptable period being taken for short-term capital gains. By default, everything sold off before this shorter period would qualify as business income.

Of course, any perceived aberrations in this generic rule could be dealt with by specific legislation to cover such exceptions. It is not out of context to note that the securities transaction tax (STT) rules have 'delivery' as the criteria for a different levy of STT. The perceived reduction in tax collections arising out of this simplification may well be offset by higher voluntary compliance by assessee coupled with the reduction in tax administrative costs in not having to administer and litigate a complex determination process.

Choose any one, but be consistent

INVESTORS have made good profits on the stock markets and the revenue department wants to treat such profits as trading income and levy a 30% tax. There has to be some consistent policy in such matters and the taxpayer should not be left to the whims of the individual tax officer assessing such income. If it is a trading income, it becomes a business income and will be subject to a tax at the rate of 30%. So, next year if the person makes a trading loss it should be treated as a business loss and he should be allowed to adjust it against his other business income.

In the past there have been bad years in the market and investors including share brokers, investment bankers, sub-brokers and financial advisors have made losses in such periods. However, in most of the cases the revenue department termed them as capital losses and not business losses. No adjustments were allowed although they were business losses as their business was dealing in stocks. If such an assessee has been showing this income as capital gains all these years and now just because the year has been good it will be unfair to treat the income as trading and tax him at a higher rate.

Stock markets are highly volatile and an increase in the frequency of trades cannot be the reason of terming it as trading income.

Two points emerge. The assessee should be free to choose for himself whether it is a trading income or a business income. That level of trust needs to be there.

For example, I may have bought a stock for investment but if the price goes up I may sell it. How can the tax authorities decide that it is trading income?

They have to have trust in the assessee. And, of course, with the trust comes the consistent following of the above choice. The assessee cannot change it every year to get preferential tax treatment. Past assessments could be the guiding posts. Once this path is followed the difference between trading income and capital gains vanishes. And along with it the litigations.

**Parag Parikh Financial Advisory Services*

FACE-OFF



GAUTAM MEHRA
Executive Director
PwC Pvt Ltd



PARAG PARIKH
Chairman
PPFAS*