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Sharp Insights

CBDT issues FAQs on long term capital gains tax regime

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Long term capital gains to be taxable

To attract investments in Indian equities and equity-oriented mutual funds, India had, since the year 2004, exempted long term capital gains (i.e. gains arising from securities held for more than a year) on these securities from tax provided the transfer is subject to Securities Transaction Tax (STT). Considering the significant investments by foreign as well as domestic investors in Indian equities and equity-oriented mutual funds over the years, this move seems to have certainly paid off.

Nonetheless, the present government seems to think differently given the resilience of equity markets and the perceived revenue loss to the government due to the current exemption in the law. Accordingly, in the Union Budget presented on 1 February 2018, the government has proposed to tax long term capital gains arising from transfer of equity shares, units of equity-oriented mutual funds, units of real estate investment trusts (REITs) and units of infrastructure investment trusts (INVITs) with effect from 1 April 2018. Fortunately, gains arising upto 31 January 2018 have been proposed to be grandfathered.

The proposed change in the regime and the way the amendment is drafted for Foreign Portfolio Investors (FPIs) raised many questions and concerns. Reacting promptly, the Central Board of Direct Taxes (CBDT) has issued a set of Frequently Asked Questions (FAQs) on 4 Feb 2018 explaining the amendment as well as how it will be implemented in different scenarios.

Clarifications provided by the FAQs

The key clarifications provided by the FAQs are discussed below:

- **Effective date** - The change is effective 1 April 2018 i.e. long term capital gains tax on transfer of equity shares (and other above mentioned securities) upto 31 March 2018 would continue to be exempt from tax.

- **Grandfathering provision** - The gains accruing as on 31 January 2018 have been grandfathered. This is done by introducing a deeming provision in the law whereby cost of acquisition of the security would be considered to be higher of the actual cost or the fair market value of the security on 31 January 2018. However, to avoid an arbitrary loss situation, if the actual sale consideration is lower than the fair market value as on 31 January 2018, the cost of acquisition would be either the actual sale consideration or actual cost, whichever is higher.

  The fair market value in case of equity shares is defined to be the highest price of the share on National Stock Exchange or Bombay Stock Exchange on 31 January 2018, or last traded date before 31 January 2018. In case of units of equity-oriented mutual fund or REITs or INVITs, the fair market value is the Net Asset Value of the units on 31 January 2018.

The above is explained with the following scenarios:

	Scenario 1	Scenario 2	Scenario 3	Scenario 4
Actual cost of acquisition (Purchase on 1 Jan 2017)	100	100	100	100
Fair market value on 31 Jan 2018	200	200	50	200
Actual sale consideration (Sale on 1 Apr 2018)	250	150	150	50
Deemed cost of acquisition	200	150	100	100
Taxable long term capital gains / (loss)	50	Nil	50	(50)

- **Applicability of grandfathering provisions to FPIs** – Allaying the fears of FPIs, it is clearly stated that the grandfathering provisions discussed above would apply in entirety to FPIs.
- **Applicability of grandfathering provisions to bonus / rights shares –** The grandfathering provisions discussed above would apply to shares received in a bonus as well as rights issue provided that such shares are acquired before 31 January 2018.
- **Non-taxable long term capital gains –** The long term capital gains upto an amount of INR 100,000 will continue to be exempt i.e. only the gains exceeding INR 100,000 would be taxable.
- **Holding period** – The holding period will be considered from the date when the security was originally acquired and not from 31 January 2018.
- **Tax withholding** – In line with the current law, there will be no tax withholding for capital gains arising to FPIs whereas for other foreign investors, tax at the rate 10% (plus surcharge and cess) would need to be withheld.
- **Long term capital loss –** The long term capital loss from sale of shares upto 31 March 2018 will not be allowed to be set-off against taxable long term capital gains for the same year and neither would such losses be allowed to be carried forward to subsequent years. This is on the basis that since the long term capital gains upto 31 March 2018 are exempt, even the losses would be under the "exempt" category and therefore not allowed to be set-off against taxable gains.

  The long term capital losses from transfers executed on 1 April 2018 can be set-off against any other long term capital gain and the net loss for the year can be carried forward to subsequent years.

Our remarks

The promptness in which the CBDT has issued the above FAQs is truly commendable. The FAQs address one of the most important concerns of FPIs that grandfathering provisions would indeed be applicable for them as well.

The other clarifications such as counting of holding period from the original date of acquisition, applicability of grandfathering provisions to bonus / rights shares and non-availability of long term capital loss on transfers starting 1 February 2018 to 31 March 2018 are also welcome as these clarifications provide certainty to taxpayers.

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