

In the Wonderland of Investments

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Budget '04 --- Ironing Out the Creases

On August 26th, the Finance (No. 2) Bill 2004 was finally passed by the Parliament without any debate or discussion from the opposition. With so may back and forths already, perhaps this was a blessing in disguise. Space constraints preclude a comprehensive commentary encompassing all the provisions of the Act. The following are some of the key changes brought about which directly affect the retail investor.

Securities Transactions Tax (STT)

No other issue in this Budget has created as much confusion and controversy as the STT imposition. Also, the continuous chopping and changing of the provisions did not help matters. The final position is as under:

Transaction	STT rate
Delivery based transaction in equity shares or units of an equity oriented fund carried out on a recognised stock exchange	Both buyer and seller pay 0.075% each
Non delivery based transaction in equity shares or units of an equity oriented fund carried out on a recognised stock exchange	Seller pays 0.015%
Redemption of units of an equity oriented fund to the mutual fund	Seller pays 0.15%
Transaction in the derivative segment	Seller pays 0.01%

All debt market deals have been completely exempted from the tax.

The two major changes are that the STT has been made largely applicable to the seller instead of the buyer. Secondly equity-oriented units have been brought within the ambit of STT applicability.

It may be noted that where the securities are held as capital asset, no deduction will be allowed for the STT in computing capital gains.

A new section, Sec. 88E has been introduced which offers a rebate in respect of STT paid to a trader in securities. In other words, where the total income of an assessee includes business profits arising from securities transactions, he shall be entitled to a rebate from the tax liability arising from such transactions. Such rebate would be limited to the amount of STT paid or the tax liability whichever is lower. Also to claim such rebate, the assessee has to furnish in the prescribed form evidence of payment of STT along with the return of income.

Long-term Capital Gains (LTCG) and Short-term Capital Gains (STCG) tax

LTCG arising from sale of equity shares or units on a recognised stock exchange or from redeeming units of an equity oriented fund to the fund itself will be exempt from tax.

STCG on the abovementioned instruments would be charged at a lower rate of 10%.

Also, for a resident individual or an HUF, where the total income as reduced by the STCG falls below Rs. 50,000, the STCG would be reduced by the amount by which the total income so

reduced falls short of Rs. 50,000 and the balance of STCG would be taxed @10%. This provision is best explained in terms of an example.

Suppose an individual has a taxable income of say Rs. 1,20,000 out of which STCG amounts to Rs. 90,000. Therefore, net of the STCG, his total income would be just Rs. 30,000, a full Rs. 20,000 below Rs. 50,000 which is the threshold below which tax is not payable. In such a case, he can use Rs. 20,000 out of the STCG to make up the shortfall and only the remaining STCG, i.e. Rs. 70,000 would be taxed @10%.

No deduction under Chapter VIA (Sec. 80DD, 80G, 80L etc.) nor rebate u/s 88 would be available on such STCG.

These changes would be applicable for transactions entered into on or after the date on which the payment of STT comes into force. Such date will be announced by notification in the Official Gazette.

Note that though the STT is applicable for sale transactions only on or after the specified date, the LTCG exemption and the STCG rate of 10% is applicable to securities bought *before*, on or after the specified date but sold only on or after the specified date.

Dividend Distribution Tax (DDT)

DDT on debt schemes has been maintained at 12.5% for individuals and HUFs but has been increased to 20% for corporates and other investors. This has apparently been done to dilute the arbitrage opportunity where corporates usually would pay tax of 35% on their normal income but routing income through the MF would entail a tax of only 12.5%.

Gift tax in another form

There is significant difference between the erstwhile gift tax provisions and the amendments made in the Budget. In short, the earlier donor based gift tax has partly been reintroduced in the form of a donee based income-tax.

From 1st September 2004 onwards, income of an individual or HUF will include any sum of money exceeding Rs. 25,000 received without consideration. The exceptions which were more in number earlier have been restricted to the amounts received from the following:

- (a) any relative; or
- (b) on the occasion of the marriage of the individual; or
- (c) under a will or by way of inheritance; or
- (d) in contemplation of death of the payer.

An interesting thing in the above modification is that the exceptions have been brought about by expanding Sec. 56. The said section appears to provide total protection to the exceptions. In other words, income without consideration in excess of Rs. 25,000 is taxable except when received from a relative or on marriage or under a will or in contemplation of death.

However, the original proposal imposed a limit on tax-exempt marriage gifts of Rs. 1 lakh by virtue of a newly introduced Sec. 10(39). This section has been deleted in the amended Act. In other words, earlier all receipts without consideration were taxable. Exception to this rule was provided by Sec. 10(39) which specified that an amount of Rs. 25,000 and a sum of Rs. 1 lakh on the occasion of marriage would remain tax-free.

Now, however, the Rs. 25,000 limit has been specifically brought into Sec. 56 directly but the Rs. 1 lakh limit is gone which means that any sum of money received as a wedding gift would be totally free of tax.

Incidentally the FM had mentioned that the definition of the term 'relative' had been streamlined in the amendments. However, it remains the same as was specified in the earlier proposal.

It may be mentioned here that the ITOs have always been empowered, before and now, to scrutinise the antecedents of the gift, if they feel the need to do so. In short, gifts from relatives have to be consistent with the financial wherewithal of the donor, else these could invite suspicion. As long as the transaction is bonafide, the donor or the donee don't have any reason to worry.

Also, a strict reading of the law seems to suggest that these new provisions are applicable to cash gifts and not to movable and immovable property gifted. It may be mentioned here that the earlier gift tax was applicable to all kinds of gifts including immovable property. A clarification on this would be helpful.

Income up to Rs. One Lakh exempt

Anyone with a taxable total income of up to Rs.100,000 (before the Sec. 88, 88B and 88D rebates) will have his income tax liability automatically rebated.

This is another area where there was some confusion among investors. In the original proposal, by virtue of a new section, Sec. 88D, tax liability on income up to Rs. 1 lakh was automatically rebated. This has not changed.

All that has been done is provisions for marginal relief have been put into place so that the take-home of those having income marginally over Rs. 1 lakh does not become less than Rs. 1 lakh just on account of the tax payable.

For example, let's take a person earning Rs. 1,10,000. The tax payable thereon works out to Rs. 11,000. The post tax income, just on account of the tax payable falls to Rs. 99,000. Ergo, such a person would get marginal relief of Rs. 1,000 such that his post tax income would be Rs. 1,00,000. The break-even income is Rs. 1,11,250.

Here queries have been raised as to what exactly constitutes total income i.e. what deductions, exemptions and rebates would be considered and which will be left out.

The term "total income" refers to the amount arrived at upon which tax is finally calculated. Ergo, all deductions (standard deduction, housing loan interest, 80 series etc.), exemptions and set-off of losses have to be considered in order to compute total income. Only rebate u/s 88, 88B and 88C cannot be considered.

Dividend & Bonus Stripping

Present : This is related with buying securities or units within a period of 3 months before the record date of dividend and selling within 3 months. Though the income is exempt, the loss arising to the taxpayer to the extent it does not exceed the income has to be ignored for computing the income. Following conditions have got to be cumulatively applicable for Sec. 94(7) to be operational —

1. The purchase has to be within 3 months before the record date for dividends.
2. The sale has to be within 3 months after the record date for dividends.
3. The dividend has to be tax-free.

Modified : 1. The period of 3 months after the record date has been extended to 9 months.

2. The loss on sale of original units where bonus units have been issued, will be ignored. The amount of such loss shall be considered as the cost of acquisition of the bonus units.

Note that —

- a) This is related only with MFs and not securities.
- b) The provision becomes applicable, irrespective of the holding period of the bonus units, 9 months or otherwise.
- c) The loss is not ignored but taken as the cost of acquisition of the bonus units.
- d) These changes are applicable for FY 04-05.

This is indeed very unkind to the MF industry. Surely, the schemes declaring daily dividends will take the worst beating.

Evidently, these provisions become inapplicable if units are purchased, say 3 months and 1 day in advance of the record date. So in the case of any MF declaring the record date more than 3 months in advance, provisions regarding dividend stripping would not be applicable. This date also needed to be extended to resolve the issue once and for all.

Tax on NRE/FCNR deferred

Earlier the Bill had sought to tax interest on NRE and FCNR accounts w.e.f. 1.9.04. This date has been extended to 1.4.05. This change has been brought about apparently to enable NRIs rearrange their financial affairs in a suitable manner.

Not that I support the proposal, but having made it, I only hope the government displays the gumption to go through with it. If it succumbs to external pressure and rolls back the proposal, in toto, the damage would already have been inflicted.

Last point

There exists an anomaly --- this time in the arena of mutual funds.

The newly introduced Sec. 10(38) as well as Sec 115T defines an equity oriented fund to mean a fund:

- (i) where the investible funds are invested by way of equity shares in domestic companies to the extent of more than 50% of the total proceeds of such fund; and
- (ii) which has been set up under a scheme of a Mutual Fund

It goes on to say that the percentage of equity share holding of the fund shall be computed with reference to the annual average of the monthly averages of the opening and closing figures.

The problem is that the definitions are unable to keep pace with the rapid developments in the MF industry. Investors are being offered a new product called Fund of Funds (FoF). Now, an equity FoF would typically invest in equity schemes of the same fund house or in equity schemes of others. Whatever the case, it firmly remains an equity product. However, a strict application of the term "equity oriented fund" defined above will make such a fund not qualify as it does not invest in equity shares of domestic companies. Consequence? It has to bear the dividend distribution tax applicable to debt-based mutual fund schemes and also forego the exemption from LTCG now available to equity funds.

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