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Transfer of Unlisted Shares: Whether 'capital gain' or "business income"

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BACKGROUND

Earlier, *vide* a Circular No. 6/2016 dated February 29, 2016 ("**Circular**"), the Central Board of Direct Taxes ("**CBDT**") tried to put to rest the prevailing ambiguity with respect to the taxability of surplus on sale of shares and securities, by laying down certain principles to determine whether an income arising on sale of listed shares and securities shall be treated as business income or capital gain income.

However, with respect to the treatment of any income arising from transfer of shares of an unlisted company, there has been multiple views prevailing among regulatory authorities, judicial tribunals and various assesses, leading to an unsettled position.

In order to settle such controversies and have consistent views, CBDT, Department of Revenue, Ministry of Finance, Government of India recently came up with a letter No. F.No.225/12/2016/ITA.II dated May 02, 2016 (the "**Letter**") addressed to relevant authorities, to determine the treatment of such income occurring on transfer of shares of an unlisted company. Further, a provision is also proposed to be inserted in the Finance Bill, 2016 to reduce the holding period of unlisted shares for the purpose of determination of capital gain tax.

THE LETTER AND PROPOSED AMENDMENT IN FINANCE BILL, 2016

The CBDT, with a view to settle the ongoing controversies with respect to the treatment of income arising from the transfer of shares of unlisted companies and to maintain consistency and uniform approach for all the assesses, has stated that any income arising from such transfer shall be treated as "capital gains" irrespective of the holding period.

However, the Letter provides for three qualifications and exceptions, wherein such income would not be necessarily treated as capital gain, which are as follows:

1) In the event, the genuineness of the transaction with respect to the shares of the unlisted company is in question,

2) If the shares of the unlisted entity have been transferred for issues relating to 'lifting of corporate veil',

3) If the control and management of the underlying business is being transferred along with the transfer of the shares of the unlisted entity.

If a transaction pertaining to the sale of unlisted securities falls in any of the aforesaid exceptions, the Assessing Officer shall take a view based upon the facts and circumstances of each case.

Recently, a proviso has also been proposed to be incorporated in the Finance Bill, 2016 (as passed by Lok Sabha on May 05, 2016) to amend clause (42A) of Section 2 of the Income Tax Act, 1961. The proposed amendment is with respect to the holding period of unlisted shares viz. in order to be categorized as long term capital asset, the period of holding of unlisted shares shall be more than twenty four (24) months instead of thirty six (36) months, as applicable earlier. Therefore, any income arising on sale of unlisted shares, having holding period of more than twenty four (24) months will attract long term capital gain tax unless such transaction falls under the ambit of any of the exceptions provided in the Letter.

OUR VIEW:

This is a significant move adopted by the CBDT, which will ideally put an end on the controversies and is a welcome step for alternative investment funds, offshore investors including private equity players, who make financial investment in shares of unlisted entities.

Although the treatment of income arising on sale of unlisted shares as capital gain has been more or less settled by way of the Letter, the interpretation/implications of the aforesaid three exceptions to be made by the Assessing Officer is yet to be seen and will lot depend upon case to case basis. The Assessing Officers have been given the wide powers to determine the genuineness of each transaction, to take appropriate view, where he opines to 'lift the corporate veil' of transaction and where whole business is being transferred through transfer of shares along with control and management. Any exercise of such power by Assessing Officer will be subject to interpretation and consequently, may lead to dispute/litigation.

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