Frequent stock trading may mean your gains are treated as business income

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Business income is taxable at normal slab rates of an individual

During the current lockdown, a large number of individual investors became active online in the stock market, buying and selling shares and, at times, also derivatives, from the comfort of their homes. This has been reflected in the large number of individual broking and demat accounts opened in recent months. Many of these investors book profits at small increases in prices, typically hold the shares for a few days or weeks, and churn their portfolios substantially. Many of them may be under the impression that the short-term capital gains (STCG) that they make will be taxed at a concessional rate of 15%. This may, however, not necessarily be the case.

It is only STCG in respect of transactions in equity shares on the stock exchange or equity-oriented mutual funds which attract the concessional tax rate of 15%. Gains on transactions in derivatives are taxed at the normal slab rates of the individual, in most cases, 30% plus applicable surcharge and cess.

Besides, in order to qualify for this concessional tax rate, the income needs to be taxable under the head “capital gains". For that, the holding of shares has to be as investments, and not as stock-in-trade of a business. If the shares are regarded as stock-in-trade, the income from the sale of such shares would be business income, which will be taxable at normal slab rates. The mere classification by the taxpayer as capital gains does not necessarily mean that it will be taxed only as capital gains.

A few years ago, the issue of whether transactions in shares amounts to a business or an investment activity was the subject of substantial litigation, with the tax authorities seeking to tax the entire gains (whether the shares were held for more than one year or less) as business income. The controversy substantially died down after the Central Board of Direct Taxation (CBDT) clarified that if a taxpayer treated his gains from shares held for more than a year as long-term capital gains (LTCG), then it had to be taxed as LTCG. It was only if such shares were classified by the taxpayer himself as stock-in-trade that the gains on sale of such shares held for more than a year could be taxed as business income. Unfortunately, the clarification does not apply to shares held for a year or less, and the litigation continues in respect of the manner of taxation of gains in respect of such shares – whether as STCG at 15% or as business income at normal slab rates.

Fortunately, besides the CBDT circulars, which have laid down guidelines, the litigation during the past few years has seen quite a few rulings by the high courts and by the tribunal, laying down the guidelines for determination of whether the income is to be classified as capital gains or business income. Besides the taxpayer’s classification of the shares as stock-in-trade or investment, other factors to be considered include the period of holding of the shares. the frequency of transactions, the volume of transactions in relation to the total portfolio, whether the shares have been acquired out of borrowed funds, whether the same shares have been bought and sold with regularity, tax treatment of such gains in earlier years, the normal occupation of the taxpayer, the time devoted to such activity, the infrastructure utilized for such activity, and so on. These and several other factors are to be considered to gauge the real intention of the taxpayer—whether to earn a return on his funds over a longer period of time (hence, taxable as capital gains), or to make a quick profit by taking advantage of short-term share price movements (hence, taxable as business income).

In case of derivatives, except if the derivatives transactions are very few and occasional or the trading has been done with an intention to hedge the physical holding of shares, the profit would normally be taxed as business income at normal slab rates of tax, because the intention in most of the cases is to take advantage of the short-term price fluctuations.

Being classified as a business for tax purposes has its own consequences in terms of tax compliances. If the turnover is less than ₹2 crore and the profits are less than 6% of the turnover, books of account have to be maintained and a tax audit is required, unless the taxpayer is declaring business income at 6% of turnover under the presumptive tax scheme. In cases not falling under the presumptive tax scheme, books of account have to be maintained. Besides, a tax audit is required if the turnover exceeds ₹1 crore. If tax audit is required for any year, the provisions of tax deduction at source apply to the individual taxpayer from the subsequent year.

Each investor, therefore, needs to relook at his stock market transactions, and based on his facts, take a call as to whether it amounts to a business or not. He needs to pay his taxes accordingly, and file his tax returns, after undertaking the required compliance, based on his perception of his transactions in accordance with the applicable law.

Gautam Nayak is a chartered accountant