Are dividend stripping and bonus stripping provisions really required?

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Long-term capital gains on sale of listed equity shares are subject to tax at 10%

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The recent budget proposes to extend the dividend stripping provisions to transactions in units of Real Estate Investment Trusts (REITs), Infrastructure Investment Trusts (InvITs) and Alternative Investment Funds (AIFs), from the existing applicability of transactions in securities and units of mutual funds (MFs). The bonus stripping provisions are now being made applicable to all securities, including shares, besides transactions in units of REITs, InvITs and AIFs.

The existing dividend stripping provisions were introduced at a time when dividends were exempt from taxation in the hands of investors, and the distributing companies paying dividend distribution tax on them. Similarly, income distribution by MFs was then exempt. At that point of time, an investor could buy the shares or units cum-dividend, receive an exempt dividend, and then sell them ex-dividend, ostensibly incurring a short-term capital loss, which was offset by a corresponding exempt dividend or MF income. Similarly, bonus stripping provisions were introduced when long-term capital gains (LTCGs) on the sale of listed equity shares and equity-oriented MF units were exempt. An investor could buy shares or units cum-bonus, and sell them after a few days ex-bonus when the price after adjusting for the bonus would be lower, and claim the difference between the original price and the post-bonus sale price as a short-term capital loss, which could be adjusted against other capital gains. The bonus shares or units, whose cost is to be taken as nil, would then be sold after a year when the LTCGs on such sale were exempt. The bonus stripping provisions were restricted to transactions in units of MFs since bonus stripping in shares was subject to the vagaries of stock prices.

These provisions were, therefore, like anti-tax avoidance provisions, designed to prevent astute taxpayers from claiming tax benefits from transactions that were commercially almost income neutral, but taxed in a manner advantageous to investors.

The position now is quite different with dividend stripping and bonus stripping no longer attractive, since dividends and income from MFs are subject to tax as normal income, while

LTCGs on the sale of listed equity shares and units of equity-oriented MFs are subject to tax at 10%. These dividend-stripping and bonus-stripping provisions were therefore hardly applicable to any transactions over the last couple of years, being mainly applicable to transactions in tax-free securities.

A new lease of life is now being sought to be given to these provisions by extending the scope. Dividend stripping provisions would apply to exempt income from REITs and InvITs, besides from AIFs. In the case of Category I and II AIFs, the income earned by the AIF is taxed on a pass-through basis, almost all of which is taxable. It is only business profits that are taxable as income of the AIF, and which are exempt in the hands of the investor. These provisions will therefore impact mainly category II or III AIFs, that too those which carry on business. Further, units of AIFs are rarely bought and sold in the secondary market – most investors hold on to their AIF investments for a few years. It will therefore impact very few transactions. Besides, the distribution to the investor is really a taxable income – it is just that the tax has to be discharged by the AIF instead of the investor.

In the case of REITs/InvITs, the exempt distribution received by the investor is only that part of the income of the REIT/InvIT which represents dividends earned from Special Purpose Vehicles (SPVs) which have paid tax on their profits at the normal corporate tax rate, and not the concessional corporate tax rate, and the return or amortization of capital by these (which is really not income but a return of capital). In most cases, the tax-free component is a small proportion of the distribution. If one looks at the distribution of the four listed InvITs and the three listed REITs, in six out of the seven, the vast majority of income is income taxable in hands of investors – it is in only in one REIT that the major part of the income is tax-free for investors. Here too, these provisions will apply only to limited cases.

Today, bonus stripping at best results in a deferral of tax liability. The explanatory memorandum does not spell out any reasons for extending the bonus stripping provisions to shares. Would it not have been better to have just deleted these provisions, particularly when General Anti-Avoidance provisions now exist?

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