EXEMPT INCOME STRIPPING (FINANCE ACT, 2022)

SECTION 94(7): MEASURES TO CURB TAX-FREE INCOME STRIPPING

♦ ANALYSIS OF SECTION 94(7) ♦

Measures to Curb Tax-free Income Stripping [Section 94(7)]

Tax-free Income stripping is a process by which an investor gets tax free income by investing in securities/units shortly before the record date and exiting after the record date at a lower price, thereby incurring a short-term capital loss. The short-term capital loss is compensated with the tax free income. Further the investor can set off such loss against other capital gains and can also carry forward the unabsorbed loss for set off in future years.

Applicability of sub-section (7) of section 94

The following three conditions have to be cumulatively satisfied in order to attract section 94(7) **in case of securities:**

- buying or acquiring any securities within a period of **THREE months** prior to the record date;
- selling or transferring such securities within a period of **THREE months** after the record date; and
- the income on such securities received or receivable by such person during the intervening period is **exempt**.

Applicability of sub-section (7) of section 94 [Finance Act, 2022]

The following three conditions have to be cumulatively satisfied in order to attract section 94(7) **in case of units:**

- buying or acquiring any units within a period of **THREE months** prior to the record date;
- selling or transferring such units within a period of **NINE months** after the record date; and
- the income on such units received or receivable by such person during the intervening period is **exempt**.

Section 94 covers holding of securities/ units both as capital assets and as stock-in-trade and hence section 94(7) would be applicable to both an investor and a trader of securities/units.

Illustration:

Mr. X buys 1,000 bonds of ABC Ltd. @ ₹ 310 per bond on 30.06.2022. Interest is payable @ 6% every year on 15th September. Mr. X receives interest of ₹ 18,000 which is tax free. Mr. X sells the bonds of ABC Ltd. on 15.10.2022 @ ₹ 300 per bond:

Answer:

Tax free interest				₹ 18,000
Capital Gains on sale of bonds	=	₹ 3,00,000 – ₹ 3,10,000	=	(–) ₹ 10,000

The short term capital loss of ₹ 10,000 shall not be allowed to be set off or carried forward as per the provisions of section 94(7).

Finance Act, 2022 has nullified the tax planning of tax free income stripping on units of business trust. Business trust is either a REIT or InVIT. Certain incomes received by unitholders of Business Trust are exempt from tax. The tax implications of income earned by REIT or InVIT and further distribution of such income to unitholders are explained as under:

Nature of Income	Taxability in the hands of		
	REIT	**InVIT**	**Unitholders**
Interest from SPV	Exempt [Section 10(23FC)(a)]	Exempt [Section 10(23FC)(a)]	Taxable [Income from other sources]
Other Interest Income	Taxable [Section 115UA]	Taxable [Section 115UA]	Exempt [Section 10(23FD)]
Dividend from SPV (SPV has exercised option under Section 115BAA)	Exempt [Section 10(23FC)(b)]	Exempt [Section 10(23FC)(b)]	Taxable [Income from other sources]
Dividend from SPV (SPV has not exercised option under Section 115BAA)	Exempt [Section 10(23FC)(b)]	Exempt [Section 10(23FC)(b)]	Exempt [Section 10(23FD)]
Other Dividend Income	Taxable [Section 115UA]	Taxable [Section 115UA]	Exempt [Section 10(23FD)]
Rental income earned from property owned by the business trust	Exempt [Section 10(23FCA)]	Taxable [Income from House Properties]	Taxable (if received from REIT) [Income from House Properties]
Rental Income from SPV	Taxable [Section 115UA]	Taxable [Section 115UA]	Exempt [Section 10(23FD)]
Capital Gains	Taxable [Capital Gains]	Taxable [Capital Gains]	Exempt [Section 10(23FD)]
Other Income	Taxable Income from other sources]	Taxable Income from other sources]	Exempt [Section 10(23FD)]

Applicability of dividend stripping provisions

Section 94(7) applies when dividend or income from the unit is exempt from tax. As discussed above, a unitholder of REIT or InVIT is liable to pay tax only on the following distributed income:

(a) Interest received or receivable from SPV;

(b) Dividend received or receivable from SPV, which has exercised the option under section 115BAA; and

(c) Rental income from real estate assets owned directly by REIT.

All other incomes distributed by the REIT or InVIT to its unitholders are exempt in the hands of unitholders under section 10(23FD).

Thus, the applicability of the tax free income stripping provision on buying or selling of units of REIT or InVIT would depend upon the nature of income distributed to the unitholder.

For example, Mr. A purchased 10,000 units of an Infrastructure Investment Fund (InVIT) at ₹ 110 per unit on 01-06-2022. The InVIT fixed 25-07-2022 as the record date for distributing income to unitholders. Based on the holding of Mr. A as on record date, the InvIT distributed the following income to him:

Particulars	Interest from SPV	Dividend from SPV	Capital Gains	Total Distribution
Per Unit	₹ 2 per unit	₹ 3 per unit	₹ 4 per unit	₹ 9 per unit
Total Amount	₹ 20,000	₹ 30,000	₹ 40,000	₹ 90,000

After receiving the distributed Income from InvIT, Mr. A sold all 10,000 units on 01-08-2022 at ₹ 100 per unit.

What shall be the tax treatment of income received by Mr. A from InvIT and the sale of units thereof? Assume that the SPV has not exercised the concessional tax regime of section 115BAA.

(A) Tax treatment of income received from InvIT

The tax treatment of income received by Mr. A from InvIT shall be as follows:

Income	Amount	Tax Treatment
Interest from SPV	20,000	Taxable
Dividend from SPV	30,000	Taxable
Capital Gains	40,000	Exempt under Section 10(23FD)

(B) Tax treatment of the sale of units of InvIT

Mr. A had acquired the units of InVIT within 3 months of the record date fixed for distribution of income and sold the same within 9 months after the record date. Thus, any loss arising from the transfer of units shall be ignored to the extent that income received from InvIT is exempt in the hands of Mr. A. The income exempt in the hands of Mr. A is ₹ 40,000, which is on account of the distribution of capital gains by InvIT. Thus, loss arising on sale of unit shall not be allowed to the extent of ₹ 40,000.
The loss, in this case, shall be computed in the following manner:

Particulars	Amount
Loss from sale of units of InvIT [10,000 units × (₹ 110 – ₹ 100)]	1,00,000
Less: Income from units exempt from tax	40,000
Loss from sale of units that can be set-off	**60,000**

Dividend stripping and units of AIF

The Finance Act, 2022 has amended the definition of the 'unit' to include the beneficial interest of an investor in an Alternative Investment Fund.

Meaning of Alternative Investment Fund (AIF)

Alternative Investment Fund (AIF) is defined to mean any fund established or incorporated in India in the form of a trust or a company or an LLP or a body corporate which, as a privately pooled investment vehicle, collects funds from investors, whether Indian or foreign, for investing in accordance with a defined investment policy for the benefit of its investors.

Categories of AIF

SEBI grants registration to AIFS on the basis of their operational strategies, objectives and fund structure and, for this purpose, they are categorized into 3 categories; Category I, Category II and Category III.

Category of AIF	Nature of Income	Tax implication in hands of AIF	Tax implication in hands of unitholders
Category I and Category II AIF	Business Income	(a) Taxable as per applicable tax rate if AIF is a Company or a Firm (b) Taxable at a maximum marginal rate of 42.744% if AIF is registered as any other body corporate [Section 115UB]	Exempt [Section 10(23FBB)]
	Other than business income	Exempt [Section 10(23FBA)]	Taxable as per applicable tax rate
Specified Category III AIF	Income from securities	Taxable, unless exempt from tax, as per the following tax rates under Section 115AD: (a) Interest or Dividend: 10%; (b) Short-term capital gain: 15% or 30%; (c) Long-term capital gain: 10%	Exempt [Section 10(23FBC)]
	Other than income from securities	Taxable as per applicable tax rate	Exempt [Section 10(23FBC)]
Other Category II AIF	Any Income	Taxable as per applicable tax rate	Taxable as per applicable tax rate

Applicability of tax-free income stripping provisions

Section 94(7) (tax free income stripping) applies when the dividend or income from units of AIF is exempt from tax in the hands of the unitholder. As discussed earlier, the exemption in respect of income from units of AIF depends on the category of AIF and nature of income. Thus, section 94(7) may not apply in all cases. For instance, if Category-I AIF distributes capital gain income to its unitholder, then it shall be taxable in the hands of the unitholder and, accordingly, section 94(7) shall not apply.