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Securities Transaction Tax

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ABSTRACT

Share operations are presently underway impacted by a broad spectrum of people in the country. The numerous provisions regarding tax legislation must, therefore, be fully realized by them and by their tax consultants adequately so that the optimum utilization of provisions providing several inducements and relief may be achieved. Vide imposition of Securities Transaction Tax, the Uni0n Budget 2004-05 suggested a prototype shifting in the taxation of capital gains on financial securities.

STT is an elegant, cost-effective, and easily managed tax having the real merit of substantially eliminating tax evasion. This research paper endeavors to demystify STT and provide justification and logic behind the acceptance of STT in the Indian Financial market[1]. The author believes at the current times, no single mechanism alone can iron out problems afflicting the Indian financial markets. However, if used in parallel with other policy tools such as banning short selling and insider trading, STT does act as a useful device to tackle the numerous challenges.

I. INTRODUCTION

Before proceeding further to understand what STT is. Let's first understand what security is. The term "security" is nothing but a negotiable financial instrument issued by a company Government that gives ownership rights, debt rights, and rights to buy or sell. They are supposed to be listed on a recognized stock exchange. In India, there are 23 stock exchanges. Amidst them, two are national-level stock exchanges, namely BSE and NSE. The rest are the Regional Stock exchange. It was in the year 2004 when the then Finance Minister, P.Chidambaram in Union Budget, introduced "**Securities Transaction Tax**" he believed STT is a clean and efficient way of collecting taxes from the financial markets. Securities Transaction Tax (STT) is a sort of turnover tax where the investor is obliged to pay a tax on the total sum received or paid in a transaction done through an exchange.

'STT' falls under the direct tax, which is chargeable on the purchasing or selling of equity and

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other trade-able securities of the companies registered on a recognized stock exchange.[3] The idea behind the born of STT was to restrain evading capital gains tax on proceeds received by transecting in securities since it was found that there were cases of evasion of capital gains taxes employing real and fictitious losses. Consequently, STT emerged as a way of realizing the true potential of taxing the stock markets.[4] STT is inapplicable on off-market dealings like commodities and currency transactions but strictly applicable to debentures, bonds, mutual funds, government equity securities, derivatives, and securities like shares.[5]

II. Demystifying STT

"Securities Transaction Tax" the name itself portrays that it is a kind of charge taxable on the transaction of securities, but the one thing which remains questionable is, which kind of securities is it applicable to? So, the rules state that whenever people will purchase or sell Equity securities, Equity mutual funds, and equity derivatives STT will apply to that. Contrary to that, the STT is inapplicable to Debt Instruments, for instance, bond, debenture, and on the purchase and sale of Mutual funds units.[6]

The application of STT is confined to equities and their derivatives, for instance, if a person purchase or sell gold ETF, then another type of tax will be imposed, not the STT. The sole aim to introduce STT was to curb the evasion of capital gains tax on profits earned given the fact that people usually did not declare their profits on the sale of stocks and avoid paying capital gain tax which left the Government taxing only those profits, which have been declared by the people.

When the reports of every transaction reach the Government, then the Government would be able to calculate the profits and gains through 0.1%[7] tax according to the reverse calculating method. This would empower the Government to keep track of the profits and gains of an investor, and if individual defaults in payment, then sanctions will be inflicted upon them. Therefore, we take STT as an instrument in the hands of the Government to keep track of income earned by the transaction of securities. The expected outcome of the Government behind the introduction of STT is that no one would be able to underreport or escape from reporting the earned income under the capital market.

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[3] Finance Minister & Shrijan Shukla, *Securities transaction tax*, 20 1–5 (2020).
[4] FE Knowledge Desk, *What is Securities Transaction Tax?*, Financial Express (May 20, 2021, 05:00PM) https://www.financialexpress.com/what-is/securities-transaction-tax-meaning/1767057/
[5] ibid
[6] Budget 2004-05: The (Modified) Turnover Tax, Macroscan (May 20, 2021, 05:03PM) http://www.macroscan.org/cur/aug04/cur020804Turnover_Tax.htm
[7] M. Raju & Trinley Pardon, *A research on the stock market volatility of BSE and NSE in the* Indian *economy*, 8 Int. J. Recent Technol. Eng. 5217–5220 (2019).

III. Efficiency of STT

To determine the efficiency of STT on the stock market, it is imperative to measure the overall effect on volume, liquidity, asset prices, and volatility. The tax, as referred to prior, can trigger the migration of trade volumes to other global untaxed/lesser burdened trading platforms. In the lack of a fundamental level of liquidity, such migration turns the (taxed) market illiquid, growing the cost of trading. An illiquid market obstructs the smooth flow of information, hampering price discovery, and lowering efficiency.[8] The tax may likewise some of the time cause the withdrawal of necessary market participants, for example, the market makers. Market makers and dealers are alluring in the case of stocks that are less often traded. They additionally help to promote price steadiness in maximum cases. An increase in volatility also implies a fall inefficiency of the market. The transaction tax is added to cause a shift in the focus of the management from short-term to long-term gains by discouraging trade by short-term traders. This argument, however, does not bolster the view that drawn-out choices long term decisions of the management may be a function of the stock prices in the short term. STT is generally accepted to cause expansion at the expense of capital. Hypothetically, as trading gets costlier in light of the introduction/increment in transaction tax/cost, investors request an increased rate of return to offset the effect of the former, which leads to an expansion in the expense of capital for companies. This further prompts a fall in the cost of the asset. In any case, contend that the expense initiates a decrease in the expense of capital and, therefore, builds resource costs.

IV. The imposition of STT on the stock market

The present analysis reveals insight into the changing patterns in volumes and turnover of the cash and derivatives sections of the NSE and BSE over a while. Derivatives here refer to only equity derivatives. Traded quantity (in lakhs) and various agreements are taken as intermediaries for trading volume in cash, and equity derivatives sections, respectively. Different measurements identified with liquidity have likewise been analyzed. There was a considerable move in volumes and turnover from money to the F&O section in the two trades in the course of the most recent decade. The compound annual growth rate (CAGR)[9] of the turnover in the F&O segment of both the NSE and BSE, was over 80 percent for the period 2001-12. The corresponding figure for the cash segment was approximately 18 percent for NSE and a meager 8 percent for BSE. NSE represented over 97 percent of the all-out derivatives turnover of the two trades for the entire period. At the same time, the combined cash volume16

[8] Securities Transaction Tax, *SECURITIES TRANSACTION TAX* * 96–100 (2018).

[9] *Securities Transaction Tax (STT)- Applicability, levy and collection, income tax implications*, CLEAR TAX (May 20, 2021, 05:08 PM), https://cleartax.in/s/securities-transaction-tax-stt

(traded quantity) grew at 17.2 percent on a compound basis, while the CAGR for the combined volume (total number of contracts) in the F&O portion was 76.1 percent in the given period.

The aim of implementing a transaction tax is to reduce excess volatility to raise market efficiency. Excess volatility is typically understood as the portion of price variability that cannot be explained by changes in fundamental data. The idea of the information arbitrage efficiency clarified above cannot be utilized to survey the impact of a transactions tax, because excess volatility need not necessarily be inefficient. Some division of data accessible is pseudo-signal, or news is containing wrong leading information. Thus, an information arbitrage efficient market that incorporates this information in its costs makes them float away from desirable costs depending on the basics. One solution might be using implied volatility, which measures only not expected price changes.

Efficiency in this meaning means fundamental valuation efficiency. In this context, excess volatility means inefficiency, and a transaction tax that lowers excess volatility contributes to a more efficient market. On financial market points, some advocates of a securities transaction tax on financial markets call attention to the peril of illiquid markets. In this manner, a transaction tax is a double-edged blade since it cuts attractive liquidity also.

One may argue that a securities transaction tax decreases market liquidity, which is endogenously determined, however. However, just suppressing the symptom (liquidity) and not the cause for market dysfunction cannot be successive in dampening excess volatility. The same may be modified for a lump sum tax, which does not have an impediment or replacement impact. Nevertheless, an ad-valorem transactions tax does influence the behavior of market participants since it generates a lock-in effect and punishes short-term investments, to which we will refer below. Thus, the tax does not exogenously lower market liquidity but diminishes incentives of (speculative) trading endogenously.

However, one may argue that taxation influence a wide range of traders. Additionally, balancing out fundamentalists will be packed out of the market if charge rates are excessively high. The outcome would be a value detachment from crucial worth. However, these misalignments will be little at low tax rates and increase with higher rates, because fundamentalists appear to trade less frequently (long horizon) than chartists (short horizon). We determine that for small tax rates, the burden of a transaction tax develops the market microstructure so that for each given liquidity, excess volatility is below the non-tax case. Support this assumption. By forcing a small transaction tax, the productivity of trading drops, and speculators leave the market. If the tax rate exceeds a critical value, deviations of exchange rates from fundamentals start to rise. He shows that a tax below around 0.5 percent improves the market structure by crowding out Chartism more than fundamentalism. At higher tax rates, misalignment increases.

V. Impact of STT

With concern to an impact, it has been seen that because of the greater STT "In the Money" option, strikes generally trade at a rebate following the expiration settlement days as purchasers try to sell their option at an equal decreased premium to escape more significant STT charges. Hence this profit comes in the hand of Option sellers as the purchaser does not practice the option until they get better profit than STT charges. The latest rule might upset the option sellers but will enhance volumes and involvement in the options section as option buyers will grow more active.[10]

Furthermore, to make it pellucid, the change to the Securities Transaction Tax is an attempt at resolving an oddity. As of now, in the options contract that is exercised, the buyer needs to pay STT at 0.125 percent of the settlement cost. In the case that the option is not worked out, the seller needs to pay STT at the rate of 0.05 percent on the option premium. Since the settlement cost is ordinarily commonly the choice premium, the higher STT demand was a dis-boosting practicing of options, leading value contortions closer to settlement. The budget is presently proposing to demand Securities Transaction Tax (STT) on the value differential between the settlement and strike cost if there should arise an occurrence of activity of choices. This would evacuate the abnormality that, at present, exists in taxing choices. With MF streams into value being reliable, the Government did not need to do anything exceptional to boost equity investing. The Securities Transaction Tax that was presented in 2004 when the assessment on long-term capital increases was pulled back keeps on being set up on both cash and derivative trade, regardless of the re-presentation of LTCG in 2018[11] on equity and equity mutual funds in 2018. While the transition to building the open shareholding will improve market liquidity in the long-term if the proposition is executed, there could be a surge by promoters to sell their shares to meet the necessity, which can prompt some short-term sell-off. Permitting higher FPI investments in organizations additionally should be thoroughly considered since excessive foreign investment is certifiably not a smart thought in various sectors. The STT change is likewise not expected to materially affect the trading volume or tax collection, as a little piece of the alternative trading volume is at present being worked out. While volatility could descend

[10] Ishani Tewari, *Securities Transaction Tax: Is It Effective?*, 39 Econ. Polit. Wkly. 4406–4410 (2004), http://www.jstor.org/stable/4415609.
[11] ibid

nearer to the expiry, the movie will not sway in some other way. The basic expectations that people were having with the budget of 2019 were the removal of LTCG and the removal of STT.[12] Nevertheless, reality turned out to be different, neither there was the removal of LTCG, nor there was any removal of STT.

However, there was a sign of relief with the update of STT on options exercise. For instance, the changes are:

STT on options expiry

Before: 0.125% on the option strike price

E.g., 20 Quantity of 32000 CE on expiry at X price

0.125* 0.01* 20* 32000 = 800 STT

Post Budget: Government imposed 0.125% on the difference between strike and settlement price.[13]

E.g.: Bank Nifty CMP: 32000

20 Quantity of 32100 CE on expiry at X price

0.125* 0.01* 20* (32100-32000) = 2.5 STT.

Before the budget 2019, the buyer had to pay 0.125% on the options strike price in case of exercising options, and if the buyer does not square off the options before the expiry. So, on the day of expiry, 0.125 used to apply on the options strike price. Earlier it is used to be calculated on the settlement price, but now it is calculating the Intrinsic value of the option. The advantages of imposing such a turnover tax, instead of capital gains tax, are involved. The introduction of an STT can control the speculation in the Indian stock market. Additionally, it is believed this new tax collection strategy to an extent assisted Government with mobilizing more income from the financial investors.

VI. Rationale of STT in the Financial Market

There have been several justifications for the approval of STT in the Indian capital markets. A few of them are as follows

Firstly, the underlying rationale of STT is to decelerate the flow of speculative money since it could be taxed every time a transaction happens. STT is intended to restrain short-term

[12] ibid
[13] *Definition of 'Securities Transaction Tax'*, Economic Times (May 20, 2021, 05:15 PM), https://economictimes.indiatimes.com/definition/securities-transaction-tax

speculation through day traders, "noise traders," hedger and significant operators in the absence of considerably influencing the long-term investors. The tax on stocks held for a prolonged period could be peripheral, whereas the tax on short-term trading will be more significant.[14] STT could be a severe constraint to speculators and day traders attempting to build a rapid profit on a considerable sum by just trading, in the absence of taking any delivery of equities. The suggested tax will push such players far away, as they will be required to factor in the tax cost.[15] STT is intended to diminish the speculation in Indian capital markets, which are amidst the many speculative markets throughout the world.

In contrast to numerous superior transnational capital markets, the enormous volume of hypothetical trading in Indian markets is exceedingly high. Notwithstanding a sharp rise in the all-day turnover in the Indian capital markets, genuine deliveries are beneath 20 percent of trading.[16] AS a result of too much speculation, a substantial part of trading in the Indian markets are focused on a small number of stocks.[17] The top 10 equities are responsible for above 80 percent of the turnover of the Indian financial markets.[18] The topmost 100 stocks are responsible for approximately 99 percent of the turnover, whereas we have several thousand shares listed in the recognized stock exchange that is not marketed at all. The risky nature of Indian financial markets may also be measured by the fact that the magnitude of secondary market exchanging has risen many times whilst fresh capital increased by the primary market has fallen considerably throughout the years. We have watched that too much speculative trading by major stakeholders more frequently than not degenerates into bid-rigging with time. There is the whole story of cheats in the capital markets beginning from the securities scam of 1992.[19] The economic frauds repeating at recurring intervals disclose that our financial markets are accustomed to misuse, deception, and excessive hypotheticals. India also possesses the discrepancy of having intense price volatility at the single-stock level. Short-term exchange is classified among significant factors accountable for raised market volatility. By increasing the cost of risky trading, STT could facilitate hindering short-term trading, therefore making Indian financial markets more stable and more competent.

<u>Secondly,</u> the revenue capacity of 0.15 percent of STT sets out another rationale. An average,

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[14] *Securities Transaction Tax*, BANKBAZAAR (May 20, 2021, 05:19 PM), https://www.bankbazaar.com/tax/securities-transaction-tax.html
[15] ibid
[16] Minister and Shukla, *supra* note 3.
[17] TAXATION OF CAPITAL GAINS : A COMPARATIVE STUDY Author (s): Gagan Kumar Kwatra Published by : Indian Law Institute Stable URL : https://www.jstor.org/stable/43951161, 30 138–165 (2020).
[18] Budget 2004-05: The (Modified) Turnover Tax, MACROSCAN (May 20, 2021, 05:03PM), http://www.macroscan.org/cur/aug04/cur020804Turnover_Tax.htm
[19] ibid

day trading in the Indian capital markets is around Rs. 1,00,000 million. By levying a 0.15 percent STT on this amount, the Government can levy Rs. One hundred fifty million every single day.[20] As Indian financial markets work at an average of 250 days per year, STT can produce earnings of Rs. 37,500 million each year. This is considerable value in the current times while the nation is finding it is tricky to increase earnings by taxation. India's tax-GDP ratio is amidst the lowermost the worldwide and has explicitly dropped in the 1990s - the years of age of economic liberalization and internationalization.

Furthermore, the ongoing need is to tax the funding economy that has continued under-taxed, although enormous expansion in recent years. In no small proportion, this has occurred as a result of multiple loopholes in the current tax system, which have experienced exploitation consistently by the big players in the financial markets. For example, the Foreign Institutional Investors (FIIs) escape paying taxes in India by conveying their investments through Mauritius,[21] which is a signatory of a double tax avoidance treaty with India.[22] Because of this treaty, corporate entities listed in Mauritius might be taxed under Mauritian law instead of Indian law. Given that Mauritius does not levy a tax on capital gains and dividends, it is hardly surprising that the majority of portfolio investment, together with foreign direct investment into India, is forwarded through Mauritius. Nevertheless, after the implementation of STT in India, avoidance of taxes by the FIIs and other multinational fund managers by such tax treaties would be successfully restricted.

<u>Thirdly</u>, a further benefit of STT is that it would dissuade 'hot money' flows recognized for their unstable and destabilizing comportment. As recent global expertise shows that building countries are prone to "hot money" flows, STT can make a sure certain degree of isolation to the Indian financial markets from the detrimental impact of such inconsistent financial flows.

<u>Fourthly</u>, by making cutbacks financial assets or resources in fruitless speculation, STT likely to stimulate long-term financial flows. The questionable practice in the financial markets deflects significant amounts of assets farther away from practical intents. As an outcome, lesser financial resources are accessible to fund long-term economic advancement. Over the longer term, STT can advantage the real economy.

<u>Fifthly,</u> the securities tax is far simpler to carry out. It is a precise and effective mechanism of levying taxes from financial markets as compilations will be concentrated and centralized

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[20] Technical Sciences & Technical Sciences, *A STUDY ON CAPITAL GAIN TAXATION IN INDIA- A CASE STUDY FROM 2010*, 120 4675–4682 (2018).
[21] *What is STT*, THE ECONOMIC TIMES (May 20, 2021, 05:24 PM), https://economictimes.indiatimes.com/markets/stocks/news/what-is-stt/articleshow/72977557.cms?from=mdr
[22] ibid

through a recognized stock exchange. Besides, STT does not demand any international consensus or agreement to levy it.[23] India, just like any other nation, is liberated to levy STT.

VII. Change in Securities Transaction Tax

The basic expectations that people were having with the budget of 2019 were the removal of LTCG and the removal of STT[24]. However, the reality turned out to be different, neither there was the removal of LTCG, nor there was no removal of STT.

Initially, the tax rate was fixed at 0.125% for a delivery-based equity transaction and 0.025% for an intra-day transaction.[25]

The tax authorities decreased this tax in the 2013 budget following many protestations over a long time by the brokers and the community of trading. The amended STT for delivery-based equity trading is 0.1% on the turnover. M[26]oreover, the tax has been decreased to 0.01% on the sell-side only. For Equity Options, the STT has been decreased to 0.05% across the sell side of the premium amount. The rest of the tax structure remains just the same.

Not long ago, the Association of National Exchanges Members of India (ANMI) has demanded the Government to revoke both Long term capital gains tax and Securities Transaction Tax[27]

It emphasized the difficulties in taxation with concern to India's equity market, which drives the Indian capital market repulsive throughout the country.

- The issues are like India is the particular country to collect a tax on stock trading in the form of Securities Transaction Tax (STT). Furthermore, Dividends are currently taxed three times in terms of corporate tax, dividend distribution tax, and finally, at the investor level, i.e., Securities Transaction Tax (STT).[28]

Corporate Tax: Indeed charged on a firm's gain by the Government.

- It turns out to be taxed on operating earnings after the expenditure have been subtracted.
- The value of corporate tax in India differs from one sort of company to another, i.e., domestic corporations and foreign corporations pay duty in varying degrees (25-50%)

Dividend Distribution Tax (DDT): Dividend relates to the allocation of benefits to stockholders

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[23] Karl Habermeier & Andrei A Kirilenko, *This paper argues that transaction taxes can have negative effects on price*, 50 165–180 (2016).
[24] Political Weekly & Political Weekly, *Taxation and Capital Market Development*, 35 2701–2702 (2020).
[25] ibid
[26] https://www.samco.in/knowledge-center/articles/what-is-stt-securities-transaction-tax/
[27] Tewari, *supra* note 11.
[28] Finance N O Bill, *Finance (no.2) bill, 2004*, 349 1–5 (2020).

of a company.

- o Hence, the dividend distribution tax is a sort of charge that is **paid on the dividends** provided to its shareholders by the corporate.
- o More enormous dividends mean a more significant tax load for the corporate body.
- o At present, the dividend distribution tax that is paid on the dividends proposed to a company's stockholders is **15%** of the lump sum allocated as a dividend.

Securities Transaction Tax (STT): As per prior discussion, this turned out to be taxed at the time of buy and sale of securities registered on recognized stock exchanges in India.

- o Both purchasers and sellers both need to pay **0.1%** of share value as STT.

VIII. Conclusion and suggestion

While supporting the enforcement of STT, it cannot be asserted that a single instrument would resolve all problems related to speculation and volatility in the Indian financial markets. However, when used in association with other policy arrangements like banning short selling and insider trading, STT does propose a powerful instrument to handle multiple issues. Hence, any endeavor to weaken the regulation of the offered tax should be vehemently objected to by all those who are concerned about volatile Indian financial markets. Share trading is now being affected by a vast range of people in the country. The several provisions of tax laws should, therefore, be realized by them and by their tax consultants properly to ensure optimal use of provisions awarding several incentives and comfort.

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