Chapter VI: Long Term Capital Gain on Penny Stocks

6.1 Introduction

Penny stocks[95] are stocks, listed on stock exchange that trade at a very low price, have very low market capitalization, are mostly illiquid. These stocks are very speculative in nature and are considered highly risky because of lack of liquidity, smaller number of shareholders and limited disclosure of information.

For making available information related to Penny Stock to the Assessing Officers (AOs), the Income Tax Department (ITD) has added a new button 'Penny Stock' on Individual Transaction Screen (ITS) in Income Tax Application Systems to display information related to penny stock[96]. Further, the Systems Directorate has uploaded details of assessees who have made transactions in such penny stock[97]. The ITD has issued a standard operating procedure (SOP) dated 21st November 2016 detailing various aspects, the AO is expected to consider inter alia, during scrutiny of a particular case.

As per Finance Bill 2017, it has been noticed that exemption provided under section 10(38)[98] of the Income Tax Act, 1961 (the 'Act') is being misused by certain persons for declaring their unaccounted income as exempt Long-Term Capital Gains (LTCG) by entering into sham transactions.

6.2 Background

The Directorate of Income Tax (Investigation), Kolkata had investigated the Accommodation Entry Operators[99] within their jurisdiction i.e. Kolkata and had identified 84 BSE listed penny stocks and conducted number of search and surveys in the office premises of more than 32 share broking entities. The entities accepted that they were actively involved in the bogus LTCG. The DIT (Investigation) conducted surveys in the office premises of many accommodation entry[100] providers and their statement was recorded.

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95 Refer "Investigation Report of the Directorate of Income Tax (Investigation) Kolkata, in case of Project Bogus LTCG through BSE Listed Penny Stocks".

96 Enforcement Information System (EFS) Instruction no. 53 of Directorate of Systems dated 08.03.2016.

97 CBDT Letter No. - F.No.287/30/2014-IT (Inv. II)-Vol-III dt. 16th March, 2016

98 Section 10(38) of the Income-tax Act, 1961 exempts long term capital gains (LTCG) arising from transfer of listed equity shares, where transfer of shares is on or after 1st October 2004 and the transaction of sale is chargeable to Securities Transaction Tax (STT).

99 As per the DIT (investigation) report, an entry operator is the person who is in the business of giving accommodation entries in lieu of cash/cheque of equal amount after charging certain percentage of commission in cash.

100 As per the DIT (investigation) report, Accommodation entry is a financial transaction between the two parties where one party enters the financial transaction in its books to accommodate the other party in lieu of cash of equal amount and commission charged over and above at certain fixed percentage. These accommodation entries are taken by various beneficiaries for introducing their unaccounted cash into their books of accounts without paying the due taxes.

The DIT (Investigation) Kolkata, from the records of the Accommodation Entry Providers identified 64,811 pan-India Beneficiaries involving suspicious exempt LTCG of ₹ 38,000 crore (approx.) and sent their report to Jurisdictional assessment wings through the DGITs.

We selected Mumbai charge for audit, as out of total suspicious exempt LTCG of ₹ 38,000 crore, ₹ 12,234 crore (32 *per cent*) involving 17,344 beneficiaries (27 *per cent*) was falling under Mumbai charge.

6.3 Modus operandi in brief

As per the "Report of the DIT (Investigation), Kolkata", the modus operandi was to make the beneficiary[101] buy some shares of pre-determined penny stock company controlled by the entry operators[102] at a very low price through exchange itself or through preferential allotment i.e. through private placement. The beneficiary holds the shares for one year, the statutory period after which LTCG received over penny stock was exempt under section 10(38) of the Act till 31st March 2018. In the meantime, operators rig the price of stock and gradually raise its price many times, often 20 to 25 times. When the prices reach desired level, the beneficiary who bought the shares at nominal price, is made to sell it to a dummy paper company of the operator. For this, the report says unaccounted cash was provided by the beneficiaries which were routed through a few layers of paper companies by the operator and finally parked with the dummy paper company also known as the Exit Provider which will buy the shares.

6.4 Audit Methodology

As per the Report of the DIT (Investigation) Kolkata, there were 17,344 beneficiaries in Mumbai who claimed exempt LTCG. A test check of cases under the Mumbai jurisdiction of the Income Tax Department was carried out by the Audit with audit objectives as given below. For the audit of assessments, 547 cases were selected across 29 CITs, out of which 499 cases have been audited. Out of the 48 cases not audited, 14 cases constituted non-production of records and remaining due to non-existence of PAN, non-availability of data, Jurisdictional charge out of Mumbai etc.

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101 Person who is in possession of unaccounted money and wants to bring this into his books without paying any tax whatsoever.

102 As per the DIT (investigation) report, an entry operator is the person who is in the business of giving accommodation entries in lieu of cash/cheque of equal amount after charging certain percentage of commission in cash.

We referred the matter to the Ministry of Finance in April 2020 for its comments. Response of the Ministry was awaited (June 2020).

6.5 Audit Objectives

a) To examine whether the Department has targeted all beneficiaries identified by the DIT (Investigation), Kolkata who were claiming exempt LTCG under section 10(38) of the Act through Penny Stock.

b) To examine whether the AOs have followed Board Instructions and SOP issued by the ITD on assessment of LTCG claims involving penny stocks.

6.6 Audit Findings

The verifications of the assessment records of beneficiaries who had traded in penny stock involving suspicious exempt LTCG under section 10(38) of the Act, were test checked and following were the findings:

6.6.1 Beneficiaries neither selected for scrutiny nor reopened under section 148 of the Act despite claiming LTCG

We noticed that in 71 cases wherein assessees involving exempt capital gain claim, the department had not taken any action in the light of report of the DIT (Investigation), where in these exempt capital gain have been treated as suspicious. Despite a new button 'Penny Stock' added on Individual Transaction Screen (ITS) in Income Tax Application Systems to display information related to penny stock and the uploading of details of assessees who had traded in such penny stock by the System Directorate, the ITD failed to scrutinize or reopen these cases in the light of claim of exempt capital gain.

6.6.1.1 In 36 cases, the assessees had claimed exemption of LTCG in ITRs but the Department failed to select these cases for scrutiny or reopen under section 148 of the Act in the light of claim of exemption of LTCG and CBDT instructions[103] on penny stock. Illustration of one case is as follows:

103 CBDT Letter No. - F.No.287/30/2014-IT (INV.II)-Vol-III dt. 16th March, 2016

(a) In the case of an Individual assessed in ACIT 17(2), Mumbai for the assessment year (AY) 2013-14, the assessee had filed ITR 2 whose schedule EI on details of exempt income revealed that the assessee had claimed ₹ 15.47 crore as exempt LTCG. In AY 2013-14 assessee had traded in shares of such companies, which were recognized as Penny stock as per DIT(Investigation), Kolkata report, with trade value of ₹ 15.37 crore. However, no action was taken to examine the veracity of the transaction in spite of the magnitude of the exempt LTCG.

6.6.1.2 In 28 cases, the assessees had not shown any capital gain in their ITRs and were neither selected by the department under CASS nor reopened under section 148 of the Act. However, as per the DIT (Investigation) Kolkata, these assessees had traded in Penny Stocks involving exempt LTCG claim. Despite availability of information in the report of the DIT (Investigation), Kolkata in respect of these assessees and CBDT instructions on penny stock, the ITD failed to examine the escapement of income under the head LTCG. One case is illustrated below:

(a) In the case of a assessee company assessed in ITO 4(3)(4), Mumbai, the return filed for *AY 2010-11 and 2011-12* in ITR 6, schedule EI of details of exempt income revealed that the assessee had shown nil exempt income. The stock exchange data used by DIT(Investigation), Kolkata showed that the assessee had traded in shares of a company (penny stock as per DIT(Investigation), Kolkata report) with trade value of ₹ 13.51 crore and ₹ 7.70 crore for AY 2010-11 and 2011-12 respectively. However, no action was taken by the Department in order to examine the escapement of income under the head LTCG.

6.6.1.3 In seven cases, audit noticed that, these assessees were involved in trading in penny stocks as per the report of the DIT (Investigation), Kolkata. However, these assessees had not filed their ITRs. The ITD neither issued notices to these assessees for filing the ITRs nor initiated any assessment procedure under section 144 of the Act. Even NMS[104] had not been utilized effectively in respect of these non-filers, which indicate the weakness of the NMS as well. One case is illustrated below:

(a) In the case of an Individual assessed in ITO 32(2)(1), Mumbai, the returns were not filed by the assessee for AYs 2014-15 and 2015-16. This case was neither selected for scrutiny nor any notice provided by the department to show the efforts taken to trace the assessee. Assessee had traded in shares of such companies which were recognized as Penny stock as per DIT

104 Non-filers Monitoring System

(Investigation), Kolkata Report with trade value of ₹ 3.89 crore. However, ITD failed to issue notice to the assessee for filing the ITR in spite of the magnitude of the exempt LTCG which might be bogus in nature. This also indicates failure of the Non-filers Monitoring System.

In reply, the department stated that, from the individual transaction Statement (ITS) query, no specific trade data regarding penny stock companies had been received in the system. Hence, audit query is not acceptable. However, the case will be reopened as a remedial action.

Department reply is not tenable as it is seen from the report of the DIT(Investigation), Kolkata that assessee has traded in these penny stocks.

6.6.2 Beneficiaries selected for scrutiny but addition in respect of Exempt LTCG involved was made inconsistently or not made.

6.6.2.1 In 21 cases we observed that Department had selected the cases for scrutiny but addition was not made in respect of the exempt capital gain claimed, despite having information available with AO through the new tab 'Penny Stock' developed in ITS and under Actionable Information Monitoring System (AIMS). The AO had not given any justification for not disallowing Exempt LTCG even though the case was selected for verifying Exempt LTCG through Penny Stock, which indicates a lackadaisical attitude of the AO and non-transparency in the workings of the Department and also non-compliance to the SOP issued by the department on assessment of penny stock cases. Three cases are illustrated below:

(a) In the case of an individual assessed in ACIT Circle 15(2)(1) for the AY *2013-14,* notice under section 148 was issued in September 2016 and reason for reopening was sale of shares of penny stock company and total sale consideration was ₹ 14.82 crore. The proceeding under section 148 was dropped on 08.05.2017 by ACIT 22(3) stating that case was transferred to ACIT 15(2)(1) charge. However, no further action has been taken by the current AO charge. This indicates a weak monitoring of actionable cases subsequent to transfer of charge which could be misused by assessees.

(b) In the case of an individual assessed in Ward ITO 22(3)((2) Mumbai for AY 2014-15, the AO in his letter dated 19.10.2016 supplied reason for reopening under section 147, that as per the DIT(Investigation), Kolkata the assessee has earned LTCG exempt of ₹ 3.21 crore from trading of penny stocks for a total trade value of ₹ 3.30 crore. Therefore, the income of ₹ 3.30 crore chargeable to tax had escaped assessment within meaning of section 147 of the Act. However, while passing the assessment order (October

2017) the AO did not discuss anything about the investment and sale consideration in respect of penny stocks and accepted the income as per return without any disallowance for LTCG on penny stocks.

(c) In the case of an individual assessed in DCIT, Central Circle-I Kanpur for AY 2012-13, search and seizure operation was conducted in July 2014 at the residential premises of the assessee. Cash of ₹ 0.10 crore and jewellery of ₹ 0.97 crore were seized. The case was centralized in this circle. Assessment order was passed in May 2017 under section 153A of the Act. It was observed from the computation of Income statement that assessee has claimed exempt LTCG of ₹ 6.06 crore from sale of shares of a company which was one of the penny stocks reported by the DIT(Investigation), Kolkata. Therefore, LTCG claimed exempt should have been disallowed by the department. However, while passing the assessment order the AO did not discuss about Exempt LTCG and sale consideration in respect of penny stock despite having information available with him through a new tab 'penny stock' developed in ITS and under Actionable Information Monitoring System (AIMS) and allowed the same.

6.6.2.2 In seven cases, AO had made disallowance in case of Entry-Exit provider as a percentage of the trade value. As per assessment orders of these individuals, all of them were used by entry provider for providing bogus accommodation entries to various beneficiaries. However, in another similar cases which were used by same entry provider, AO had made 100 *per cent* disallowance. Thus there is inconsistency in the disallowance made during the assessments. One case is illustrated below:

(a) In the case of an individual, assessed in ITO 30(1)(5), Mumbai for AY 2014-15. The case has been selected for scrutiny under CASS with a reason suspicious sale transactions in shares (Penny stock in ITS). The assessee being one of the exit provider, had purchased the penny stock shares of company. In the assessment order, department disallowed five *per cent* of the total cash deposit of ₹ 6.36 crore amounting to ₹ 0.32 crore stating that assessee is an Exit Provider. However, in a similar case of a company assessed in DCIT(CC) - 8(3), Mumbai, where assessee company was an exit provider and trading in shares of same company, the department had disallowed 100 *per cent* of total purchase and entire amount was added. Thus, clear inconsistency is evident in assessments.

6.6.3 Inconsistency in dis-allowance of Sale consideration and commission expenses

6.6.3.1 We noticed that in the treatment of bogus LTCG transactions there was no uniformity in additions made in the Assessment orders passed by the AOs. The SOP issued by the department on assessment of penny stocks prescribes that in case of prearranged claim of LTCG entire sale proceeds received on sale of shares is to be added as taxable income under section 68 of the Act, without any eligibility of exemptions under section 10(38) of the Act. Moreover, while disallowing the bogus LTCG in 32 cases department had disallowed the total sale consideration, where as in 43 cases department disallowed claim of net LTCG only. One case is illustrated below:

Section 68 of the Act provides that, if assessee offers no explanation about the nature and source of any sum credited in the books of the assessee, the sum so credited may be charged to income tax as income of the assessee.

In the case of an individual assessed in Circle 31(3) Mumbai for AY 2013-14, the assesse had claimed ₹ 5.20 crore exempt under section 10(38) of the Act. Assessee has received ₹ 5.41 crore as sale proceeds. The ITD had disallowed the net capital Gain of ₹ 5.20 crore only which was claimed exempt, under section 68 of the IT Act, 1961. However, in the case of an another individual assessed in Ward ITO 17(3)(1) Mumbai, for the AY 2014-15, the assessee had claimed ₹ 10.82 crore exempt under section 10(38) of the Act. The ITD had disallowed the amount of ₹ 11.01 crore received as sales proceeds of shares under section 68 of the Act.

6.6.3.2 There is a cost attached to getting undisclosed income converted into disclosed income, disallowed by the department as commission expenditure. We noticed that there was no consistency in the approach in disallowing the same. In 40 cases disallowance on account of commission was not made whereas in 69 cases commission disallowance varied from 0.5 to 5 *per cent*. Two cases are illustrated below:

Section 69C of the Act provides that, if assessee offers no explanation about the source of any expenditure incurred by the assessee in any financial year such expenditure may be deemed to be the income of the assessee for charged to income tax as income of the assessee for such financial year.

(a) In the case of an individual assessed in December 2017 in Ward ITO 18(2)(5) Mumbai for AY *2015*-16*,* the assessee had taken entry from an entry operator who had admitted in his statement recorded by the investigation Wing, Kolkata that he was providing the accommodation entries to beneficiaries by charging commission. The ITD disallowed ₹ 5.27 crore as unexplained investment being bogus profit on sale of shares of penny stock company. Further, the commission at the rate of 0.50 *per cent* was disallowed by the department as unexplained expenditure under section 69C of the Act.

(b) In the case of an individual assessed in December 2017 in Central Circle 2(2), Mumbai for AY 2014-15*,* the assessee had taken entry from entry operator. The operator had admitted in his statement recorded by the investigation Wing, Kolkata that he was providing the accommodation entries to beneficiaries by charging commission. The ITD disallowed ₹ 12.74 crore as unexplained investment being bogus profit on sale of shares. Also the ITD disallowed the payment of commission at the rate of five *per cent* as unexplained expenditure under section 69C of the Act.

6.7 Conclusion

The ITRs of the assessees who traded in the shares of penny stock companies were neither selected for scrutiny nor reopened for scrutiny despite the ITD having information of claiming LTCG. The ITD failed to issue notices for filing ITRs, to the assessees who were involved in trading penny stocks, but have not filed their ITRs. Even Non-filers Monitoring System had not been utilized effectively to identify such non-filers. The AOs had no uniformity in making additions of exempt LTCG, despite the fact that the grounds of additions were same. In some cases, AOs did not make any addition for claimed exempted LTCG, for which no justification was given in the assessment orders. Further, the AOs had made additions at different percentage where the assessees traded in shares of same penny stock companies. The ITD did not have any systemic approach to deal with cases of beneficiaries traded in penny stock as in some cases entire sales consideration was disallowed whereas in some cases only claimed LTCG was disallowed. There is also variation in disallowance of commission received by entry and exit provider from beneficiary of penny stock.

It is recommended that

(i) the ITD may design CASS parameters in such a way that all the relevant information with ITD, whether from ITR or other sources, may be used to select the cases for scrutiny.

(ii) the method of selection for scrutiny under CASS may be shared with the C&AG as was pointed out in the Audit Report No. 9 of 2019 of C&AG so that audit may see whether the selection of cases for scrutiny is as per CASS parameters.

(iii) the ITD may examine whether the errors in assessment of cases where LTCG on penny stock was claimed, are errors of omission or commission and if these are errors of commission, then ITD should ensure necessary action as per law.

New Delhi
Dated: 03 August 2020

(Neelesh Kumar Sah)
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Countersigned

New Delhi
Dated: 04 August 2020

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Comptroller and Auditor General of India