

Penny Stocks Manipulation and LTCG Fraud in India

Executive Summary: -

This article explains how some people are using penny stocks—very cheap and low-volume shares—to cheat the tax system. They buy these shares at a low price, then work with others to artificially increase the value. Later, they sell the shares at a high price and show this as a legal profit to claim tax benefits under Long-Term Capital Gains (LTCG). In reality, these gains are often fake and used to turn black money into white. The article looks at how this scam works, real-life examples, and what government agencies like SEBI and the Income Tax Department are doing to stop it. It also suggests that stricter rules are needed to prevent this kind of financial fraud in the future.

HOW THE SCAM WORKS – STEP BY STEP:

1. BUYING PENNY STOCKS CHEAP

- A person (the scammer) buys shares of a penny stock—a company with very low share prices and little trading activity.
- These stocks are often of shell companies (companies that exist on paper but have no real business).

2. PRICE MANIPULATION

- The scammer works with stock brokers or operators to artificially increase the price of that stock over time.
- This is done by fake trading—buying and selling between known people or accounts to create a false sense of demand.

3. HOLDING FOR OVER A YEAR

- The person keeps the stock for over 1 year so it qualifies for LTCG (Long-Term Capital Gains) exemption under tax laws (this used to mean no tax on the profit).

4. SELLING AT HIGH PRICE

- After the price is pumped up, the person sells the stock at the inflated price and shows a huge profit.
- On paper, it looks like a legal investment gain.

5. CLAIMING TAX-FREE OR LOWER TAX RATE INCOME

- The profit from selling the stock is shown as LTCG and the person claims it as tax-free income or income that comes under the lower bracket of tax rates.
- In reality, the money was either black money or a fake transaction.

REAL LIFE EXAMPLE:

Here are a few real-life examples of LTCG scams involving penny stocks, based on actual incidents from India (which is known for its regulatory measures around LTCG exemptions):

1. The Suman Poddar Penny Stock Case (2018)

The Suman Poddar case is a prominent example of penny stock manipulation in India, where bogus LTCG claims were made using illiquid and low-priced stocks.

- **How it worked:** Suman Poddar, an individual investor, was involved in a scheme where he manipulated the prices of penny stocks by engaging in round-tripping (a technique of buying and selling stocks among related parties). The prices of these stocks were artificially inflated, and after holding them for over a year, Poddar sold the stocks, claiming the profits as Long-Term Capital Gains to evade taxes.
- **The Scam:** Through the manipulation of stock prices and trading volumes, Poddar was able to falsely claim large tax-free profits, taking advantage of the LTCG exemption that applied to stocks held for over one year.
- **Outcome:** The case came under investigation by the Income Tax Department and SEBI. Poddar was accused of tax evasion and market manipulation. As a result, the authorities froze his accounts, and he was required to pay back the taxes along with penalties. This case drew attention to the increasing misuse of tax exemptions and the growing concern of tax fraud involving penny stocks.

2. The 2017-18 Penny Stock Manipulation Case

In 2017, SEBI (Securities and Exchange Board of India) uncovered a large scam involving penny stocks. The scam involved multiple investors who were allegedly using low-priced, illiquid stocks to inflate their prices and claim long-term capital gains (LTCG) tax exemptions.

- **How it worked:** The manipulators bought huge amounts of penny stocks at very low prices and then artificially pumped the prices by making fake buy/sell transactions among themselves. Once the stock price was significantly inflated, they sold the shares

at the higher price, showing large profits and claiming LTCG benefits, which are exempt from tax if held for more than a year.

- **Outcome:** SEBI investigated the case, froze accounts involved, and imposed penalties. The Income Tax Department also sent notices to those involved, requiring them to pay taxes on their gains.

3. The 2018-19 Alleged LTCG Tax Fraud Scheme

In 2018, the Income Tax Department and SEBI investigated multiple cases of manipulated penny stocks that were used to claim fraudulent LTCG exemptions.

- **How it worked:** Investors allegedly bought shares of low-volume companies with a history of small or no trading. These stocks were then manipulated in a way that created the illusion of genuine price rise. After holding the shares for more than a year, the investors sold them and declared the profits as LTCG, making the income exempt from taxes.
- **Outcome:** Several investors were found to have violated tax laws, and tax notices were issued demanding taxes along with penalties. The case raised concerns about market manipulation, especially in penny stocks.

4. The Karvy Stock Broking Scam (2020)

Karvy Stock Broking, one of India's largest brokerage firms, was allegedly involved in a stock manipulation case that included penny stocks.

- **How it worked:** The brokers involved in this scam were accused of manipulating share prices by executing fake trades, inflating stock prices, and facilitating the creation of fake LTCG claims. Investors were able to claim tax exemptions on their inflated profits from penny stocks.
- **Outcome:** The scam came to light when the SEBI started investigating unusual trading patterns, and Karvy was found to be involved in the manipulation. The company was penalized, and many of the investors who participated were asked to explain their tax filings.

5. The Ahmedabad Penny Stock Scam (2021)

In Ahmedabad, a major penny stock scam came to light where investors were involved in a similar LTCG tax fraud scheme.

- **How it worked:** The manipulators bought penny stocks from non-performing or low-value companies and then rigged the market by driving up the prices through a series

of fake trades. The investors involved in the scheme then claimed the profits as LTCG, making them eligible for tax exemptions under India's tax laws.

- **Outcome:** Tax authorities issued show-cause notices to those involved, and several market manipulators were caught in the web of this illegal activity. This brought attention to the loopholes in penny stock trading.

WHAT GOVERNMENT AGENCIES LIKE SEBI AND THE INCOME TAX DEPARTMENT ARE DOING TO STOP IT:

1. Securities and Exchange Board of India (SEBI)

SEBI is the primary regulatory body overseeing the securities market in India. To combat penny stock manipulation and LTCG fraud, SEBI has taken several steps:

- **Surveillance and Monitoring of Trading Activities**
 - SEBI constantly monitors trading activities to detect unusual patterns, such as sudden spikes in penny stock prices or abnormal trading volumes.
 - The agency uses advanced data analytics and algorithmic tools to flag suspicious trading activities in real-time.
- **Investigation and Enforcement**
 - SEBI investigates cases where it suspects market manipulation, such as false price rigging or round-tripping (buying and selling stocks between related accounts to create artificial demand).
 - When manipulation is found, SEBI freezes accounts, bans market participants, and imposes fines on stock brokers, operators, or companies involved in these fraudulent activities.
- **Penalties and Actions Against Offenders**
 - SEBI has the power to bar individuals or companies from trading in the securities market.
 - The agency has also penalized individuals who were found guilty of manipulating penny stocks to claim fake LTCG profits.
- **Investor Awareness**
 - SEBI also runs awareness programs to educate investors about risk management and how to avoid falling for scams like fake LTCG claims.
 - They provide resources to report suspicious activities to ensure market integrity.

2. **Income Tax Department**

The Income Tax Department (ITD) plays a key role in investigating and addressing fraudulent LTCG claims. Here's how the department is working to combat the misuse of LTCG exemptions through penny stocks:

○ **Scrutiny of Tax Filings**

- The ITD performs scrutiny of tax returns to identify abnormally high claims of LTCG, especially when investors report huge tax-free profits from penny stocks.
- They use software tools and data analytics to cross-check and detect any discrepancies in tax filings related to capital gains from suspicious stock trades.

○ **Investigation and Tax Recovery**

- If an individual or entity is found to have claimed bogus LTCG, the Income Tax Department conducts detailed investigations into the source of funds and the transactions.
- Tax demands are raised against those who are caught claiming fraudulent LTCG exemptions, including penalties and interest on the unpaid taxes.

○ **Issuing Notices**

- The ITD often issues notices to individuals who have made false LTCG claims, requiring them to explain their investments and income sources. If no satisfactory explanation is provided, the department can disallow the LTCG exemption and impose taxes on the gains.

○ **Prosecution and Legal Action**

- In extreme cases of serious tax evasion, the Income Tax Department can initiate criminal prosecution under the Income Tax Act, leading to fines or even imprisonment for offenders.

○ **Cooperation with SEBI and Other Agencies**

- The ITD works closely with SEBI, financial institutions, and other regulatory bodies to track down market manipulators and ensure that fraudulent tax claims do not go unnoticed.

3. **Other Steps Taken by the Government**

○ **Tightening of Tax Exemption Rules**

- In 2018, the Indian government revised tax rules to curb misuse of LTCG exemptions. Under the new rules, long-term capital gains on listed shares exceeding ₹1 lakh are now taxable, reducing the scope for fraud in the stock market.

- **Ban on Trading in Suspicious Stocks**

- SEBI has banned trading in certain penny stocks and suspended companies with suspected involvement in market manipulation. This limits the possibility of artificially inflating stock prices for LTCG claims.

- **Whistleblower Mechanism**

- The government has introduced mechanisms to encourage whistleblowers to report market manipulation and fraud.
- SEBI and the Income Tax Department actively seek information from the public to investigate suspicious activities in the stock market and tax filings.

What Needs to Change to Stop These Scams:

Penny stock scams and bogus LTCG claims thrive on loopholes in regulation and monitoring. Here are the key reforms and rule changes needed to prevent such financial frauds:

1. **Stricter KYC and Source of Funds Verification**

Ensure investors declare the origin of their funds, especially for high-risk penny stock trades.

2. **Real-Time Monitoring of Penny Stock Activity**

Use technology to track sudden price spikes or trading volume surges in illiquid stocks.

3. **Full Disclosure of Beneficial Ownership**

Identify the real individuals behind shell companies and suspicious transactions.

4. **Audit and Scrutiny of High LTCG Claims**

Automatically flag unusually large tax-free capital gains for investigation.

5. **Restrict LTCG Benefits for Illiquid Stocks**

Exclude or limit tax exemptions on gains from low-volume or non-performing stocks.

6. **Widespread Investor Education Campaigns**

Educate retail investors about the risks of penny stocks and how scams operate.

7. **Improved Coordination Between Regulators**

Encourage seamless data-sharing among SEBI, the Income Tax Department, RBI, and banks.

8. Harsher Penalties and Faster Legal Action

Impose tougher punishments and speed up the legal process for offenders.

Conclusion:

At the heart of the LTCG scam through penny stocks is a simple trick—buy low, fake the rise, and cash out tax-free. While it might seem clever on the surface, it's nothing more than a loophole used to dodge taxes and clean up black money. These kinds of manipulations hurt not just the system, but honest investors too.

Thankfully, agencies like **SEBI** and the **Income Tax Department** are catching on. With tighter rules, smarter tech, and more eyes on suspicious trades, it's getting harder for these scams to slip through the cracks. Real cases, like the **Suman Poddar example**, show that the consequences are real—and growing.

At the end of the day, the market works best when it's fair and transparent. Cleaning up these shady practices is a big step toward building trust and making sure the financial system works for everyone—not just the ones gaming it.