

Tax Hotline

January 25, 2005

DERIVATIVES INCOME HELD TO BE BUSINESS INCOME FOR AN FII

The recently delivered advance ruling that had been sought by Morgan Stanley and Co. International (a UK tax resident) is significant for its reiteration of the position on the classification of the income of a Foreign Institutional Investor ("**FII**") as business income. This follows the ruling of the Authority for Advance Rulings ("**AAR**") in the Fidelity case, where gains on sale of shares were held to be business income.

The Morgan Stanley case involved the question of whether Morgan Stanley and Co. International ("**Applicant**"), a SEBI registered FII that had been trading on the stock market and offering its income from the same to tax under the head "capital gains", could classify its income from derivatives (that it now proposed to trade in) as income from business, on which it would be subject to no taxation in India, as it did not have a Permanent Establishment ("**PE**") in India. The Applicant proposed to trade on the Indian stock exchange through more than one broker and custodian who rendered similar services to several FIIs besides the Applicant.

In opposing the stand of the Applicant the revenue representative argued that "capital gains" from the sale of securities being specifically provided for under the ITA, the income of the Applicant could not be classified as business income. He also argued that, should the income in question be classified as business income, it would still be taxable in India as the Applicant had a PE in India by virtue of its brokers and custodians forming a dependent agent PE. In this context, the recent Mumbai tribunal ruling in the DHL Operations case was relied on, where it was held that while determining dependent agency PE, it must be examined if the non resident is wholly dependent on the agent for its operations in India, and it is irrelevant that the Indian agent conducts business for various non resident principals.

In giving its verdict, the AAR considered various Indian judgments on the classification of income from the trading of shares. Judging on the basis of the volume of purchase and sale of securities, the ratio of sale to purchase, the period of time that the securities are held for, the object for which the securities are purchased and other factors, the AAR came to the conclusion that the income of the Applicant would be classified as income from business, and not as capital gains, as the derivative instruments were held as "stock-in-trade", which was specifically excluded from the definition of a "capital asset" under the ITA.

The AAR disagreed with the interpretation of PE in the DHL Operations case, and held that dependence of an agent was to be determined from the perspective of the agent and therefore neither the brokers nor the custodians would constitute PE of the Applicant in India. It may be noted that the advance rulings are private and binding on the revenue authorities only in case of the applicant. However, they do have persuasive value, where facts are identical.

Source: Morgan Stanley & Co International Limited., *In re* [2005] 272 ITR 416

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