

Tax Hotline

May 19, 2006

BUSINESS INCOME OR CAPITAL GAINS - WHAT'S THE DIFFERENCE? NEW DRAFT INSTRUCTIONS BY THE INDIAN TAX DEPARTMENT ATTEMPTS TO CLARIFY

The Central Board of Direct Taxes ("CBDT") proposes to issue supplementary Instructions to Instructions no.1827 dated 31.08.1989, which are guidelines to an Assessing Officer ("AO"), in determining whether a person is a **trader** in stocks or an **investor** in stocks. The CBDT has invited comments of all stakeholders by May 25 before issuing the instructions.

The distinction as to whether the income arising from sale of shares would be capital gains or business income would determine the taxability of the investor. If it is capital gains, then the long term capital gains is exempt under the Income Tax Act, 1961 ("ITA") provided the applicable Securities Transactions Tax ("STT") is paid by the buyer and the seller. The short term capital gains tax on listed securities on which applicable STT is paid is 10%, (increased by the applicable surcharge and education cess). However, if the income is treated as business income, then, the same would be subject to tax at the rate of 41.82% in the hands of a foreign investor or at the rate of 33.66% in the hands of a resident investor.

It is stated that the draft instructions are supplementary to the instruction no. 1827 issued by the CBDT on August 31, 1989, to provide further guidelines in determining whether a person is a trader in stocks or an investor. The draft instructions enumerate 15 criteria, with an advice to the tax officer that the total effect of all these criteria should be considered to determine the nature of activity and hence the nature of the income. These criteria are as follows:

1. Whether the purchase and sale of securities was allied to his usual trade or business / was incidental to it or was an occasional independent activity.
2. Whether the purchase is made solely with the intention of resale at a profit or for long term appreciation and/or for earning dividends and interest.
3. Whether scale of activity is substantial.
4. Whether transactions were entered into continuously and regularly during the assessment year.
5. Whether purchases are made out of own funds or borrowings.
6. The stated objects in the Memorandum and Articles of Association in the case of a corporate assessee.
7. Typical holding period for securities bought and sold.
8. Ratio of sales to purchases and holding.
9. The time devoted to the activity and the extent to which it is the means of livelihood.
10. The characterization of securities in the books of account and in balance sheet as stock in trade or investments.
11. Whether the securities purchased or sold are listed or unlisted.
12. Whether investment is in sister/related concerns or independent companies.
13. Whether transaction is by promoters of the company.
14. Total number of stocks dealt in.
15. Whether money has been paid or received or whether these are only book entries.

Over the years, the Indian courts have discussed general principles while determining the character of income in such situations. This list attempts to compile all those principles. However, it is not clear how does a criteria such as whether the transaction is by promoters of the company would really affect the determination. Further, it would be useful to prescribe weightage to each of the criteria and to clarify how many minimum criteria need to be satisfied for making the determination. This would make the determination more objective and transparent rather than leave it to the discretion of the tax officer, thereby rendering it open to litigation. That would defeat the very purpose of the instructions that they seek to achieve.

Though the intention is to provide clarity especially with respect to determining the taxability of foreign investors, such as Foreign Institutional Investors, Private Equity Funds and other Offshore Funds, the draft instructions would create more onerous tax burden on domestic small investors, especially pensioners, housewives, retired persons, who engage in such investment activity as a means of enhancing their meager income. So far such investors would have only been subject to 10% tax on short term capital gains. Now, if they were regarded as traders, they would be taxed at the rate of 33.66%.

As regards foreign investors, those coming from treaty countries would be taxed on business income only if they have a permanent establishment ("PE") in India and the income is attributable to the PE. In case the income is capital gains, to the extent that it is exempt under the ITA, the foreign investors will also not be taxed in India. Those investors who are residents of jurisdictions such as Mauritius, Singapore or Cyprus and eligible to the beneficial

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treaty provisions, they would not be taxed even on the short term capital gains in India, if the income were to be considered capital gains and they do not have a PE in India. Only the foreign investors who are not protected by a tax treaty could have tax implications in India if their income is regarded as business income since they could be considered to have a business connection in India under the ITA and the income would then be taxed at the rate of 41.82% as opposed to 10% in case of the short term capital gains. Rulings given in cases such as Fidelity Investment Trust, TCW-ICICI and Morgan Stanley have examined this issue in detail and have ruled that the income would be business income based on the factual position of each applicant. The present instructions appear to indicate that such income would be treated as business income and not capital gains, which means that the litigious forums for such foreign investors who do not have a PE in India, would be passñ.

The CBDT has invited comments from public before finalizing the above instructions. This indeed is very commendable and indicates the importance that the CBDT gives to the consultative process and to the concerns of the stakeholders .

- **Daksha Baxi & Bijal Ajinkya**

Source:

- *CBDT Draft Instructions dated May 16, 2006*
- *CBDT Instruction no. 1827 dated August 31, 1989*

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