

Tax Hotline

June 16, 2007

FII TAXATION: NEW CBDT CIRCULAR SAYS IT'S A MIXED BAG

The much awaited Circularⁱ ("Circular") by the Central Board of Direct Taxes ("CBDT") on the issue of when the income of a person, from the sale of shares should be treated as capital gains or as business income is finally out. The Circular, issued to aid the tax authorities in distinguishing between shares held as capital assets as against trading assets, supplements the earlier instructions of 1989ⁱⁱ. The Circular has restated the principles of recent decisions of the Authority for Advance Rulings ("AAR") and the prevailing precedents of the Supreme Court and summarises the following principles in determining the issue: (i) holding of investments as stock-in-trade, (ii) manner of maintaining accounts, (iii) magnitude of transactions, (iv) substantial nature, (v) profit motive. The Circular has reiterated that the determining consideration is a mixed question of law and fact.

Importantly, the Circular has advised the tax authorities to consider the total effect of all principles in determining whether a person is an investor or a trader in stocks and not only rely upon the business objects of the entity, which may be merely permitting it to buy and sell shares. This should help clear the air for long term investors such as venture capital or private equity funds on the characterization of the gains from their investments.

The subject matter of the Circular has attained much importance of late, especially in the context of foreign investors investing from tax treaty jurisdictions (such as FIIs), as in the event the income of the foreign investor from the sale of shares is treated as business income, it would not be taxable in India in the absence of a permanent establishment. In the above background the distinction was the subject matter of consideration at forums such as the AAR. In one of the early rulings involving FIIs, the AAR in the matter of *Fidelity Advisor Series VIII*ⁱⁱⁱ, ruled that the income of the applicant FII would be business income based on the factual position that it held its investments as stock-in-trade, it was trading in shares with the motive of earning profit and *inter-alia*, fulfilling the general principles discussed above.

Subsequently in a recent ruling of the AAR in *Fidelity Northstar Fund, In re*^{iv} along with the analysis as per the principles, regulatory aspects of foreign investments were also examined by the AAR. The AAR concluded that the actual determination of the nature of transaction was a mixed question of law and fact and also noted that the FII regulations suggested that FIIs could only realize capital gains from the sale of shares. The reliance on the FII regulations for the purpose of characterisation in our view is misplaced. The observations relevant to the above reasoning from this ruling also have been quoted in the Circular.

Thus as regards FIIs, while the Circular states that all the factors have to be considered in totality in determining whether an entity is a trader or investor, by citing the above reasoning of the *Fidelity Northstar Fund* ruling, the CBDT appears to have kept alive the debate on the characterization of the income of FIIs.

It is also interesting to note that the Circular has also recognised an important conception that a person may have two portfolios, *i.e.*, an investment portfolio and a trading portfolio. Thus, an assessee may have income under the head of capital gains and business income. This seems to suggest that even in the case of FIIs, the actual nature of the transaction should determine its characterization as opposed to a regulatory classification on the nature of income that an FII can have. Hence, the onus is on the FII to prove that it has dealt with shares as a trader as opposed to an investor. In the event that these foreign investors were treated as traders, if they invest from jurisdiction which has a tax treaty with India, their business income will not be taxable in India in the absence of a permanent establishment in India. While if the income was held to be capital gains, then the same would be subject to tax in India in the absence of a beneficial tax treaty in this regard, between India and the jurisdiction of the investor.

- Nithya Reddy & Shefali Goradia

Source:

- [1] "Distinction between shares held as stock-in-trade and shares held as investment - tests for such a distinction"- Circular No. 4/2007, Dated 15-6-2007;
- [2] CBDT Instruction no.1827 dated 31-08-1989
- [3] [2004] 271 ITR 1
- [4] [2007] 288 ITR 0641

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