

Tax & regulatory services

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Recent Circular - Characterization of income on sale of securities

Background

As per the provisions of the Income-tax Act, 1961 [‘the ITA’], ‘business income’ and ‘capital gains’ are subject to tax at different rates of tax. The provisions of the ITA do not lay down clear criteria for determining the characterization of income, but certain generic principles have evolved out of the judicial precedents and administrative dispensation.

Earlier in 1989¹, certain tests were laid down by the Central Board of Direct Taxes [‘CBDT’] to distinguish between shares held as stock-in-trade and shares held as investment. The CBDT then issued draft supplementary instructions on May 16, 2006² to provide further guidelines for determining whether a person is a trader in stocks or an investor in stocks, and had included fifteen indicative criteria in this determination and had invited public comments thereon. The CBDT has now issued a Circular no. 4/2007 dated June 15, 2007 in this regard.

Highlights of the Circular

The said Circular, issued as a supplement to the earlier Instruction of 1989, reiterates the principles laid down in the earlier judicial decisions and more specifically, reproduces certain observations made in the two decisions of the Supreme Court³. These observations are to the effect that whether the transactions of sale and purchase of shares are trading transactions or whether these are in the nature of investment is a mixed question of law and fact and that whether a particular holding of shares is by way of investment or forms part of the stock-in-trade is a matter which is within the knowledge of the assessee [tax payer] who holds the shares and who should, in normal circumstances, be in a position to produce evidence from its records as to whether it has maintained any distinction between those shares which are its stock-in-trade and those which are held by way of investment.

The Circular states that the above decisions afford adequate guidance to the Assessing Officers. The Circular further refers to the decision of the Authority for Advance Rulings [AAR] in Fidelity Northstar Fund and others In re 288 ITR 641 [2007], where the Authority had ruled, in the light of the specific facts of the case of the Applicant who was a Foreign Institutional Investor [‘FII’], that the shares were held by the Applicant as capital assets and not as business assets. In this context, it has referred to the following three principles in the said Ruling:

- Where a company purchases and sells shares, it must be shown that they were held as stock-in-trade and that existence of the power to purchase and sell shares in the memorandum of association is not decisive of the nature of transaction;
- the substantial nature of transactions, the manner of maintaining books of accounts, the magnitude of purchases and sales and the ratio between purchases and sales and the holding would furnish a good guide to determine the nature of transactions;
- ordinarily the purchase and sale of shares with the motive of earning a profit, would result in the transaction being in the nature of trade/adventure in the nature of trade; but where the object of the investment in shares of a company is to derive income by way of dividend etc., then the profits accruing by change in such investment (by sale of shares) will yield capital gain and not revenue receipt.

Foreign Institutional Investors (‘FII’) are governed by special provisions in the Act dealing with taxation of the income earned by them. Typically, most FIIs characterize their gains on sale of the securities as ‘capital gains’. However, some FIIs had characterized their income as ‘business income’ and not ‘capital gains’. In terms of the

provisions of the Double Tax Avoidance Agreement (DTAA) signed by India with various countries, 'business income' earned by a tax resident of these countries can be subject to tax in India only if the tax resident has a 'permanent establishment' in India.

Importantly, the Circular recognises that a assessee could have two portfolios viz., investment portfolio, comprising of securities which are to be treated as capital assets and trading portfolio, comprising of stock-in-trade which are to be treated as trading assets.

The CBDT has advised Assessing Officers to consider the total effect of all the principles outlined in the above judicial decisions in determining whether the shares are held by the assessee as investments, giving rise to capital gains or as stock in trade, giving rise to business profits.

The above Circular is a generic one and has repercussions on the determination on characterization of income from sale of shares covering all assesseees.

Conclusion

The Circular has not appeared to have set any new principles in determination of characterization of income in the hands of the tax payer but has reiterated certain observations/principles brought out by earlier judicial decisions.

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- 1 Instruction No.1827 dated August 31, 1989
- 2 F.No.149/287/2005-TPL from CBDT
- 3 Commissioner of Income-Tax (Central), Calcutta v. Associated Industrial Development Company (P) Ltd 82 ITR 586 and Commissioner of Income Tax, Bombay Vs H. Holck Larsen 160 ITR 67