

Tax Hotline

October 11, 2004

GAINS ON SALE OF SHARES TREATED AS 'BUSINESS INCOME' IN THE HANDS OF FIIS

In a recent tax ruling pronounced by the Authority for Advance Rulings ("AAR") it was held that, gains arising to Foreign Institutional Investors ("FIIs") on sale of their portfolio investments in India were in the nature of business income, and would not be taxable in India in the absence of a permanent establishment ("PE") in India.

The applicant in this case was an investment fund organised in the US and invested in India under the FII route. The ruling was sought from the AAR for the specific determination as to whether gains arising in India from the trading of shares would be regarded as business income or capital gains.

Currently, while long term capital gains on listed securities are tax exempt in India under the domestic law, a 10% tax is levied on short term capital gains on listed securities. In the case of unlisted securities, long term capital gains are subject to tax at the rate of 10%, while short term capital gains are taxed at the rate of 30%.

While pronouncing that the gains were in the nature of business income, the AAR laid down the following principles:

- Mere power in the byelaws to trade in shares is not decisive of the nature of transaction. It must be established that a company dealing in shares is holding the same as stock in trade;
- Substantial nature of transactions, manner of maintaining records and magnitude of transactions are relevant factors in determination of the nature of transactions; and
- Trading in shares with the motive of earning profit would result in the transaction being regarded as adventure in the nature of trade.

The AAR also examined as to whether the applicant had a PE in India due to the presence of a custodian in India. The AAR after perusing the custodian agreement and various other documents held that the custodian was an agent of independent status and hence would not be treated as a PE in India. Thus, relying on the provisions of Article 7 of the India-US tax treaty, they held that in the absence of a PE in India, the trading income of the applicant will be taxable only in the US and cannot be taxable in India.

It should be noted that advance rulings are binding only on the applicant and in respect of the specific transaction in relation to which such advance ruling was sought.

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