

Fidelity Northstar Fund and ors.

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Court : Authority for Advance Rulings

Decided On : Jan-08-2007

Judge : S S Quadri, A Narang, A Sinha

Appellant : Fidelity Northstar Fund and ors.

Judgement :

Syed Shah Mohammed Quadri, J. (Chairman), A.S. Narang and A. Sinha, Members 1. In this batch of forty cases, thirty applications are filed by Fidelity Group of USA, nine by the Fidelity Group of Canada and one by the Matthews India Fund. All these applications are filed under Section 245Q(1) of the Income-tax Act, 1961 (for short 'the Act') to seek advance rulings of the Authority on the questions mentioned therein.

Inasmuch as the germane questions in all the applications are common, we propose to decide them together. The applicants have taken up application No. AAR/694 of 2006 filed by Fidelity Hastings Street Trust (from USA group) as representative of facts in all other cases. The applicant in AAR/694 of 2006 (for short 'the applicant') is a scheme of investment fund organized as a Massachusetts Business Trust under the laws of Commonwealth of Massachusetts (USA). It is set up to provide investors a continuous source of managed investments in securities. It is registered under the Investment Company Act 1940 of USA and is treated as a Corporation for purposes of taxation in USA. The beneficial interest in the funds is divided into transferable shares of one or more separate and distinct series. The applicant is being managed by a Board of

Trustees, which has the authority and discretion in regard to investment/re-investment of its fund and the power to declare and pay dividends. It makes investment in different parts of the world including India. It is registered with the Securities Exchange Board of India (SEBI) as a sub-account of Fidelity Management and Research Company (FMR). Under the Foreign Institutional Investors regime the applicant invests in shares in Indian companies. To comply with the SEBI regulations the applicant appointed Brown Brothers and Harriman Company as its global custodian who in turn appointed Citibank NA, Mumbai as its correspondent to act as domestic custodian for the applicant. Both the global custodian and the domestic custodian are acting in the ordinary course of their business and are performing similar custodial services for many other FIIs. The applicant is regulated by the laws in force in the commonwealth of Massachusetts USA and by the Securities Exchange Commission. The investment manager of the applicant, FMR, is located outside India and it has no presence in India. The applicant does not have any branch office or place of business in India. It purchases and sells shares/securities in India through brokers and the securities are held by the domestic custodian on behalf of the applicant. It is mentioned that the name of the applicant has undergone change and the changed name is Fidelity Hastings Street Trust Fidelity Discovery Fund w.e.f. August 23rd, 2003, which has been acknowledged and approved by the SEBI. On these facts the applicant seeks advance ruling of the Authority on the following questions:

1. Whether on the facts and in the circumstances of the case, the profits arising to Fidelity Hastings Street Trust: Fidelity Discovery Fund (hereinafter referred to as the 'Applicant') from the sale of portfolio investments in India will be treated as business income of the Applicant?
2. Whether on the facts and in the circumstances of the case, the Applicant can be regarded as having a Permanent Establishment ('PE') in India in accordance with Article 5 of the Agreement for Avoidance of Double Taxation and Prevention of Fiscal Evasion with Respect to Taxes on Income entered into between the Government of the Republic of India and the Government of the United States of America (hereinafter referred to as the 'Treaty')?

3. Whether on the facts and in the circumstances of the case, if the income is found to be in the nature of business income, in the absence of a PE in India and in light of the provisions of Article 7 read with Article 5 of the Treaty, such business income of the Applicant will be taxable in India?

4. Whether on the facts and in the circumstances of the case, if it is found that the Applicant has a permanent establishment in India under the Treaty and if the income is found to be in the nature of business income, the business income of the Applicant in India from the sale of portfolio investments will be taxable in India at the rate of 20% in light of Section 115AD of the Income Tax Act, 1961 (hereinafter referred to as the "ITA")?

2. In the comments of the Commissioner it is not disputed that the applicant is a trust registered under the provisions of the Investment Company Act 1940 of USA; that it is set up to provide investors a continuous income from managed investment in securities and it principally invests in equity shares. The applicant, it is stated, makes investment in India under the FII regime and for this purpose it is registered with SEBI as a sub-account of FMR which was registered as a FII under the SEBI regulations. In compliance with the regulations, the applicant appointed J.P. Morgan Chase Bank (JPMCB) which in turn appointed Hongkong & Shanghai Banking Corporation (HSBC) as domestic custodian of the applicant.

The Commissioner raised a preliminary objection with regard to the jurisdiction of the Authority to pronounce ruling on the questions formulated by the applicant. Referring to the definition of 'advance ruling' in Section 245N of the Act, it is urged that the Authority can make determination in relation to a transaction which has been undertaken or is proposed to be undertaken by a non-resident applicant but in this case the applicant seeks advance ruling with regard to series of transactions, therefore the Authority has no jurisdiction to pronounce rulings sought for. Without prejudice to the preliminary objection it is submitted that the applicant is a trust and derives its status as a sub-account of the FII and is treated as separate taxable entity from the FII. The applicant is a non-resident under Section 6 of the Act. All the income that accrues or arises or received or deemed to accrue or arise or received by the applicant in India shall be taxable in India as

provided in Section 5 of the Act. As sales and purchases of securities by the applicant take place in India, the income from such transactions in securities accrues, arises or is received in India.

Alternatively the income shall be deemed to accrue or arise in India in view of provisions of Section 9(1)(i) of the Act. It is submitted that for the purpose of characterization of income the following are the relevant factors: (1) the provision of FII scheme under which the applicant has been allowed to operate in India; (ii) special provisions of the Act; and (3) nature of transactions and operating processes of the applicant. To attract investment from abroad guidelines were issued by the Government of India vide Press Note dated 14th September, 1992 for the benefit of FIIs, which were subsequently modified. Clause (f) of para 2 of the SEBI regulations, which defines FII, says that an institution is registered as FII only when it proposes to make investment in India. Regulation 18 imposes an obligation to maintain books of account and records. The said regulations show that FII shall make investment to realize only capital gains on transfer of securities. Even the old regulations postulate repatriation of only capital gains, dividends and interest income. There is no provision which entitles the applicant to repatriate the business profits out of India. The very concept of the investment implies purchasing capital assets which yield income. Under the scheme a special provision, Section 115AD, was inserted in the Act by the Finance Act 1993 which speaks of taxability of income of FII in respect of securities or by way of long term capital gain or short term capital gain arising on transfer of securities and provides that no deduction under Sections 28 to 44C and 57 of the Act would be allowed. Had the intention of the Parliament been to allow a FII to trade in securities the business income would have been allowed to be computed under Section 28 to 44C of the Act. Further, any income payable to a non-resident is subject to deduction of tax at source but Section 196D of the Act, a special provision meant for FIIs, provides that in the case of a FII income tax has to be deducted at source in respect of income from securities but not from capital gains in regard to which a FII has to specify an agent for the purpose of Section 163 of the Act to obviate the need for deduction of tax at source from the capital gains.

It is noted that non-resident entities from jurisdictions where capital gains are exempted from taxation, are claiming the yield from transactions of sales and purchases of securities on Indian stock market as capital gains while in respect of identical transactions some others treat the income arising therefrom as business profits. The intention of the scheme as disclosed in inviting FIIs for investment in India by the press note and making consequential changes in the Act, is that regardless of volume or frequency of transactions the investments in securities by such FIIs, shall be as capital investments giving rise to capital gains. This is also reflected to in the ruling of the Authority in University Superannuation Scheme Ltd.¹ With regard to the rulings of the Authority in M/s Morgan Stanley & Co International Ltd², M/s Fidelity Advisor Series VIII, USA³ and XYZ/ABC Equity Fund⁴, it is pointed out that in those cases full facts and legal issues involved were not brought to the notice of the Authority.

It is submitted, the claim of the applicant that it is trading in securities and that the transactions do not give rise to capital gains, is not supported by following documents: (i) Annexure-II of the application; (ii) Trust deed Article (V) of Section 1; (iii) SEBI's letter dated 21.12.2005.

On the contrary they show that the activities of the applicant were in the nature of investments in capital assets for earning capital gains. From various transactions in securities in India by the applicant it is seen that the applicant is in the habit of keeping its holding in various Indian companies from a few months to a few years which clearly indicates that the motive and intention of the applicant is to earn return in the form of capital gains rather than earning business profits. In the case of trading, the securities which are subject matter of purchases and sales would be termed stocks-in-trade and not investments. The intention of the FII, as is evident from the circumstance at the time of purchases of securities, is a relevant factor and often a conclusive factor in determining whether a transaction is in the nature of trade or in the nature of investment. A Fund Manager who is located outside India, is appointed for the purpose of managing applicant's fund in India and he takes decision to acquire and sell securities in India, instructs broker in India for transactions in securities as also the custodian regarding payments and delivery of securities. The domestic custodian keeps stocks of securities, receives and

delivers the securities and maintains bank account of the FII. Both of them receive their fees and commission. The activities of the Fund Manager and the Custodian are not akin to the activities of business venture but are in the nature of investment and management of properties. In view of the objectives of the trust, special status of the applicant as a FII, the SEBI guidelines under which it is allowed to operate and the special provision of the Income-tax Act, it can be inferred that the applicant has been engaged in investment activities and not in trading activities. Therefore the income from those securities by way of interest and dividends will be taxable under the head income from other sources and profits from the transfer of such securities are taxable as capital gains.

It is, further, pleaded that having regard to articles 1 & 4(b) of Indo-US treaty (for short 'the treaty') the applicant, being a trust, has placed no material to show that it is subject to tax in USA and therefore it cannot be treated as tax resident of USA so as to derive the benefit of the treaty. Even if it is entitled to the benefit of the treaty capital gains arising from transfer of securities are taxable in India. In regard to the permanent establishment (PE), it is submitted that paras 2 & 3 of article 5 of the treaty the custodian/NSDL or CSDL and the office of the stock broker may together as also individually constitute sales outlet since selling of goods to outsider is involved and the whole transaction of sale (contract, delivery and payment) takes place in India. Even the US Treasury technical explanation also states that regular delivery of goods may constitute a PE. Stock and shares are within the meaning of goods, therefore, the applicant has a PE within the meaning of article 5(2)(b) of the Treaty. It is added that M/s Hongkong & Shanghai Banking Corporation, Mumbai would constitute a PE of the applicant in India under article 5(4) of the Treaty.

3. The applicant filed a rejoinder to the comments of the Commissioner reiterating and elaborating the pleas and contentions raised in the application. We shall advert to those aspects while discussing the respective contentions of the parties.

4. Mr. T.N. Chopra, learned Counsel appearing for the Commissioner, has put forth a preliminary objection as to the jurisdiction of the Authority to entertain these applications. The premise on which this objection proceeds is that Section 245N of

the Act defines 'advance ruling' as determination by the Authority in relation to a transaction which has been undertaken or is proposed to be undertaken by a non-resident applicant so also in relation to the tax liability of a non-resident in relation to a transaction , but in each of these applications a series of transactions are involved, therefore, the Authority has no jurisdiction to pronounce ruling in regard to series of transactions. Mr. Nishith Desai , learned Counsel appearing for the applicant, has argued that as per Section 13 of the General Clauses Act 1897 in all Central Acts and Regulations, words in the singular shall include the plural and vice-versa. We may observe that on the face of it the preliminary objection raised by the Commissioner lacks not only merit but also rationality. After some reluctance Mr. Chopra has given up this objection, we, therefore, do not propose to deal with this aspect any further except to mention that Section 13 of the General Clauses Act 1897 is a complete answer to the objection raised by the Commissioner.

5. The germane question in all these applications is : whether securities which are the subject matter of purchases and sales by the applicants, are held by the applicant by way of stock-in-trade so as to give rise to business income or investment in capital assets so as to yield capital gains. Mr. Desai has contended that the term 'investment' is not determinative of the nature of the income arising from a transaction and that it would depend on the intention and the circumstances. For the purpose of the income-tax the term "investment or investments" is to be taken in the business sense of laying out money for profit and the nature of the income has to be considered as per the income tax statute and not in the context of FII Regulations and not with reference to the terminology employed. The Income-tax Act and FII Regulations are not *pari materia* therefore, the Regulations cannot be taken into consideration for arriving at the character of income for the purpose of levy of income tax. The applicants devote their entire resources to the earning of income by trading in securities and do so after study and research in business like manner; merely because some securities are held by the applicant for relatively longer period the income from transactions in securities cannot be considered capital gains. Mr. Chopra would contend that registered FIIs are permitted under the Securities Exchange Board of India Act, 1992 (SEBI Act) and the Regulations issued thereunder and also Foreign

Exchange Management Act (FEMA) and the Regulations made thereunder, to make investment in the capital market in India. Further repatriation of capital gains along with interest and dividend is permitted under the framework of SEBI and FEMA. SEBI monitors and controls the capital market and the Regulations framed under Section 30 of the SEBI Act are binding on FIIs and that on registration of sub-accounts under regulation 13(2) of SEBI Regulations, they shall be deemed as FIIs therefore the regulations are binding on the applicants. Investments by FIIs are subject to the guidelines issued by the Government of India.

Regulation 18 of SEBI Regulations enjoins maintenance of proper books of account and this also indicates that FIIs are permitted to invest to earn capital gains and not for carrying on trading activities in securities. It is argued that trading is permitted only in respect of derivative contracts and that there is no regulation, which permits trading in securities. The learned Counsel has also relied on Section 115AD of the Act to point out that this special provision deals only with two types of income of FIIs, namely, income received in respect of securities like dividends and interest etc., and income by way of short term and long term capital gains arising from the transfer of such securities.

We find no force in the contention of Mr. Desai that for the purpose of classification of income the terminology or the context used in the FII Regulations cannot be used to determine the nature of the transaction as the FII Regulations are drafted in a generic manner and cannot be determinative of the character of income as the Income Tax Act and the regulations and other enactments are not *pari materia*. We are of the view that the classification of income has to be done under the law of the land and once it is classified under any of the heads of income under Section 14 of the Act, the relevant provisions of the Act appropriate to that head of income will apply.

6. The polemics in regard to whether an investment made by a FII in Indian securities gives rise to business profits or capital gains is being raised before the Authority from time to time. We can with advantage refer to the following observation of the Hon'ble Supreme Court in CIT, Bombay v. H. Holck Larsen⁵ that the question whether the transactions of sale and purchase of shares were

trading transactions or were in the nature of investment was a mixed question of law and fact In Fidelity Advisor Series VIII USA (Supra 3), the Authority pointed out that whether a company was an investment company or a trading company or whether any amount received by a person was a revenue receipt or capital receipt was a mixed question of law and facts which had to be decided on the facts and circumstances of each case. After discussing the decisions of the Hon'ble Supreme Court in Raja Bahadur Visheshwara Singh and Ors. V. CIT, Bihar & Orissa⁶, Dalhousie Investment Trust Co. Ltd. V. CIT^{Central}), Calcutta⁷, CIT Nagpur V. Suttlej Cotton Mills Supply Agency Ltd.⁸, A.V. Thomas & Co. Ltd. V. CIT⁹, CIT v. P.K.N. Co. Ltd.¹⁰ and CIT v. Associated Industrial Development Co (P) Ltd.¹¹ and ruling of the Authority in XYZ/ABC Equity Fund (Supra 4), the Authority noted the following principles: 1. 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; 2. substantial nature of transactions, manner of maintaining books of accounts, 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; 3. ordinarily purchase and sale of shares with the motive of earning a profit, would result in the transaction being in the nature of trade/an 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.

In this case it is a common ground that the intention of the investors is an important factor in determining the above question. In applying the aforementioned principles, it will be useful to bear in mind the following extracts from the decision of Hon'ble Supreme Court in CIT Bombay v. Holck Larsen (Supra The second question is what are the legal principles applicable to the facts of these types of cases to determine whether the conduct was that of dealer in shares or of an investor in share.

How in the case of sale of shares, the object or the purpose of selling the shares, in order to determine whether one was a dealer in shares or an investor in shares,

should be viewed, may be looked at from the angle of Lord Reid in *J. Harrison (Watford) Ltd. v. Griffiths* (H.M. Inspector of Taxes) [1962] 40 TC 281 (HL), when he observed (p. 295): if this was not trading, what was it? With all deference to those who have used that argument, I do not think that it is very useful in most cases. Human affairs- and business affairs- are of infinite variety. They do not fit neatly into categories or classes.

Innominate contracts and transactions are of frequent occurrence, and I would not expect to find appropriate names to denote new kinds of operations devised for the sole purpose of gaining tax advantages. In the present case the question is not what (sic) [whether] the transaction of buying and selling the shares lacks to be trading, but whether the later stages of the whole operation show that the first step- the purchase of the shares- was not taken as, or in the course of, a trading transaction.

The real question as Lord Reid said was not whether the transaction of buying and selling the shares lacks the element of trading, but whether the later stages of the whole operation show that the first step-the purchase of the shares was not taken as, or in the course of, a trading transaction .

In order to ascertain whether the first step- the purchase of the shares was not taken as, or in the course of, a trading transaction we shall commence our discussion by making a survey of legal framework and circumstances prevailing at the time when India extended the invitation to Financial Investors abroad for investments in Indian capital market and the facts of the case. The financial year 1992-93 witnessed a marked shift in the policy of the Government of India in regard to allowing the Foreign Institutional Investors/Individuals to invest in Indian capital market. While presenting the budget for the year 1992-93 the Hon ble Finance Minister, inter alia, announced - we will also consider ways of allowing reputable foreign investors, such as pension funds, to invest in our capital markets, with suitable mechanisms to ensure that this does not threaten loss of management control.

In furtherance of that policy the SEBI guidelines for FIIs were issued vide Press Note dated 14.9.1992¹². The relevant portion of the guidelines are reproduced

hereunder: 1. The Reserve Bank of India's general permission under the Foreign Exchange Regulation Act would enable the registered FII to buy, sell and realize capital gains on investments made through initial corpus remitted to India, subscribe /renounce rights offerings of shares, investment on all recognized stock exchanges through a designated bank branch, and to appoint a domestic custodian for custody of the investments held. (d) make investments in securities in India out of the balance in the rupee account; (f) repatriable the capital, capital gains, dividends, incomes received by way of interest etc., and any compensation received towards sale/renouncement of rights offerings of shares subject to the designated branch of a bank/the custodian being authorized to deduct withholding tax on capital gains and arranging to pay such tax and remitting the net proceeds at market rates of exchange.

10. There would be no restriction on the volume of investment minimum or maximum- for the purpose of entry of FIIs, in the primary/secondary market. Also there would be no lock-in period prescribed for the purposes of such investments made by FIIs. It is expected that the differential in the rates of taxation of the long-term capital gains and short-term capital gains would automatically induce the FIIs to retain their investments as long term investments.

1. FIIs investing under this scheme will benefit from a concessional tax regime of a flat rate tax of 20 per cent on dividend and interest income and a tax rate of 10 per cent on long-term (one year or more) capital gains. Necessary legislative amendment giving effect to this will be brought at the time of the 1993-94 Budget.

All FIIs investing under the scheme even in 1992-93 will be covered.

The modified guidelines for FIIs (Taxation Aspect)¹³ were issued by Press Release dated 24.3.1994. The following extracts are material for the present discussion; Modified Guidelines for Foreign Institutional Investors (Taxation Aspect) The following modifications of FII Guidelines dated 14.9.92 in general, and paragraph 9(f) and paragraph 18 of those Guidelines in particular, are issued by way of clarification in the light of the enactment of Section 115AD of the Income-tax Act through the Finance Act, 1993: The taxation of income of Foreign Institutional Investors from securities or capital gains arising from their transfer, for

the present, shall be as under: 1. The income received in respect of securities (other than unit of offshore Funds covered by Section 115AB of the Income-tax Act) is to be taxed at the rate of 20%; 1. Income by way of long-term capital gains arising from the transfer of the said securities is to be taxed at the rate of 10%; 2. Income by way of short-term capital gains arising from the transfer of the said securities is to be taxed at the rate of 30%; 1. The rates of income-tax as aforesaid will apply on the gross income specified above without allowing for any deduction under Section 28 to 44C, 57 and Chapter VI-A of the Income-tax Act.

On Account of the concessional rate of income-tax on the capital gains, the provisions currently available to non-residents for protection from fluctuation of rupee value against foreign currency for computing capital gains arising from the transfer of shares in, or debentures of, an Indian company, will not apply to the Foreign Institutional Investors covered under Section 115AD of the Income-tax Act. Further, the benefit of cost inflation indexation will also not be available to FIIs while computing long-term capital gains arising to them on transfer of securities.

1. Income of Foreign Institutional Investors from securities shall be subject to deduction of tax at source. However, no deduction of tax shall be made from any income by way of capital gains arising from the transfer of securities. In order that the tax on capital gains arising to FIIs can be realized, each FII, while applying for initial registration with Securities and Exchange Board of India, will have to specify an agent, including a person who is treated as an agent under Section 163 of the Income-tax Act for the said purpose.....

In conformity with the said policy, various enactments and regulations were passed; among them are: Securities Exchange Board of India Act, 1992 (for short "the SEBI Act"), SEBI (Foreign Institutional Investors) Regulations, 1995 (hereinafter referred to as "SEBI Regulations") framed in exercise of the powers conferred by Section 30 of the SEBI Act; Finance Act 1993 which inserted Section 115AD in the Act for the purpose of levy of income tax at concessional rate on the income of FIIs from securities and capital gains arising from their transfer, (we shall advert to this provision presently); Financial Exchange Management Act, 1999 (for short 'the FEMA'); Foreign Exchange Management (Foreign Exchange

Derivative Contracts) Regulations, 2000 (for short the "FEM Regulations (Derivatives) of 2000) and Foreign Exchange Management (Transfer or Issue of Security by a Person Resident Outside India) Regulations 2000 (for short "the FEM Regulations (Security) of 2000*"). These regulations were framed in exercise of the powers conferred under the FEMA. Regulation 5 of the FEM Regulations (Security) of 2000 deals with permission for purchase of shares by certain persons resident outside India. Sub-regulation (2) of regulation 5 provides that a FII may purchase shares or convertible debentures of an Indian company under the Portfolio Investment Scheme, subject to the terms and conditions specified in Schedule 2 of the said Regulations. Schedule 2 deals with , inter alia, maintenance of account by a registered FII for routing transactions of purchase and sale of shares/convertible debentures and remittance of sale proceeds of shares/convertible debentures. Para 3 of Schedule 2 speaks of allowing remittance of net sale proceeds to the registered FII. Clause (f) of regulation 2 of SEBI Regulations defines the "Foreign Institutional Investor" to mean an institution established or incorporated outside India which proposes to make investment in India in securities. The proviso to that clause says that a domestic asset management company or domestic portfolio manager who manages funds raised or collected or brought from outside India for investment in India on behalf of a sub-account, shall be deemed to be a Foreign Institutional Investor. Sub-account has been defined in Clause (K) of the said regulations to include foreign corporates or foreign individuals and those institutions established or incorporated outside India and those funds, or portfolios, established outside India, whether incorporated or not, on whose behalf investments are proposed to be made in India by a FII. The expression "Government of India Guidelines" is defined in Clause (h) of said regulations to mean the guidelines dated September 14, 1992 issued by the Government of India for FIIs as amended from time to time. Chapter II of these regulations deals with the registration of FII. It is provided in regulation 3(1) that no person shall buy, sell or otherwise deal in securities as a Foreign Institutional Investor unless he holds a certificate granted by the Board under these regulations. SEBI Regulation 12 speaks of application for registration of sub-accounts. Sub-regulation (3) of SEBI Regulation 13 is worth quoting - A sub-account granted registration in accordance with sub-regulation (2) of this

regulation shall be deemed to be registered as a Foreign Institutional Investor with the Securities and Exchange Board of India for the limited purpose of availing of the benefits available to Foreign Institutional Investors under Section 115AD of the Income Tax Act.

This sub regulation shows that a sub-account is granted registration as FII with the SEBI for the limited purpose of availing of the benefits available to FII under Section 115AD of the Act. It is enjoined by Regulation 14 of SEBI Regulations that a FII shall not make any investments in securities in India without complying with the provisions of chapter III (comprising of Regulations 14 to 15A) which deals with 'investment conditions and restrictions'.

Regulation 15(1) enumerates securities in which a FII may invest.

Further, SEBI Regulation 15 (7) declares that the investment of the FII shall also be subject to Government of India Guidelines (referred to above). Sub-regulation (1) of Regulation 15A provides that a FII or sub-account may issue, deal in or hold, off-shore derivative instruments such as Participatory Notes, Equity Linked Notes or any other similar instruments against underlying securities, listed or proposed to be listed on any stock exchange in India, only in favour of those entities which are regulated by any relevant regulatory authority in the countries of their incorporation or establishment, subject to compliance of 'know your client' requirement and Sub-regulation (2) thereof, requires a FII or sub-account to ensure that no further downstream issue or transfer of any instrument referred to in Sub-regulation(1) is made to any person other than a regulated entity. SEBI Regulation 18 enjoins every FII to maintain proper books of accounts, records etc.

and reads as under: 18. (1) Every Foreign Institutional Investor shall keep or maintain, as the case may be, the following books of accounts, records and documents, namely: 1. true and fair accounts relating to remittance of initial corpus for buying, selling and realizing capital gains of investment made from the corpus; (emphasis supplied) accounts of remittances to India for investments in India and realizing capital gains on investments made from such remittances; (emphasis supplied) (2) The Foreign Institutional Investor shall intimate to the Board in writing the place where such books, records and documents will be kept or maintained.

From a perusal of Clauses (a) and (b) of this regulation it is amply clear that the investment made from the corpus fund in buying and selling securities is for realizing capital gains.

Provision was also made for repatriation of the capital gains etc. In this connection Clause (f) of para 9 of the SEBI guidelines for FIIs is worth noticing. The guidelines are given effect to by making FEM Regulations (Security) of 2000. The expression, Investment on repatriation basis is defined in Clause (vi) of Regulation 2 of FEM Regulations (Security) of 2000 to mean an investment the sale proceeds of which are, net of taxes, eligible to be repatriated out of India.

Regulation 11(2) of FEM Regulations (Security) of 2000 provides that an authorized dealer may allow the remittance of sale proceeds of a security (net of applicable taxes) to the seller of shares resident outside India subject to conditions contained in the proviso thereto.

The application form for registration of FII contains a declaration and undertaking. The relevant portion of the undertaking is reproduced hereunder: - 3. We further undertake that we shall comply with the provisions of the Act, and regulations issued thereunder and all other relevant laws including guidelines issued by the Reserve Bank of India and the Government of India.

4. We further undertake that as a condition of grant of certificate of registration, we shall abide by such operational instructions/directives as may be issued by Securities and Exchange Board of India and by the Reserve Bank of India from time to time under the provisions of the Act or any other law for the time being in force.

Mr. Desai has placed reliance on the SEBI Regulations 3(1); 15(3)(a); 15(3)(c) and Circular No. FITTC/CUST/23920/2002 dated December 6, 2002 issued by the FITTC department of the FII Division, SEBI and pleaded that trading activities are not prohibited under the scheme. The Circular states that SEBI has introduced the facility to directly upload these FII trades/investments by local custodians. The regulations referred to above read as follows: (1) No person shall buy, sell or otherwise deal in securities as a Foreign Institutional Investor unless he holds a

certificate granted by the Board under these regulations.

(3) in respect of investments in the secondary market, the following additional conditions shall apply: 1. the Foreign Institutional Investor shall transact business only on the basis of taking and giving deliveries of securities bought and sold and shall not engage in short selling in securities; 2. the transaction of business in securities shall be only through stock brokers who has been granted a certificate by the Board under Sub-section (1) of Section 12 of the Securities and Exchange Board of India Act, 1992; A close reading of the regulations, quoted above, particularly the portions underlined therein, on which reliance is placed by Mr.

Desai, do not give any scope for reading in them the permission for trading in securities. The expression or otherwise deal in in regulation 3(1) means other than buying and selling, e.g.

lending/borrowing permitted under regulation 15(8) of SEBI Regulations. It cannot be understood to mean doing business in securities because trading itself involves buying and selling and if it is construed to mean trading as urged by Mr. Desai, the expression will become otiose. It cannot be lost sight of that regulation 15A of SEBI Regulations referred to above, permits dealing in offshore derivative instruments only and none other. The words transact business and the transaction of business in Clauses (a) & (c) respectively of Sub-regulation (3) of Regulation 15 postulate transaction of sale and purchase, they do not refer, as such, to the trading activity. It needs no emphasis to point out that transact business is different and distinguishable from carrying on business. Transact business is a general term which refers to carrying on all types of activities whereas business transaction refers to only commercial trading activities.

Thus it follows that the aforementioned words and expressions, in the context in which they are used, do not deal with the subject of trading in securities much less do they permit activities of trading in securities by a FII. In no way, the framework of the provisions of the Guidelines, Acts and Regulations, discussed above, can be so interpreted as to lead to the inference that trading in Indian securities is open to the FIIs.

It may be apposite to point out here that regulation 5(6) FEM Regulations (Security), 2000, specifically provides that FII having approval under FERA and FEMA may trade in all exchange traded derivative contracts approved by SEBI. Further regulation 3 of the FEM Regulations (Derivative) 2000, prohibits that no person in India shall enter into a foreign exchange derivative contract without the prior permission of the Reserve Bank and accordingly the exchange traded derivative is specifically permitted. In contrast there is no provision in the aforementioned Acts, Regulations or Guidelines of Government of India, permitting trading in other securities. The obvious inference is that trading in other securities is not permitted; in other words trading in securities other than exchange traded derivatives is prohibited.

From a careful reading of the above provisions, it becomes evident that the whole scheme meant for FIIs is to invest in securities in India to receive income from them so long as they hold the same and realize capital gains on their transfer.

7. We shall now turn to Section 115AD of the Act. In so far as Sub-sections (1) and (2) thereof are relevant for the present discussion, they are extracted as under: Tax on income of Foreign Institutional Investors from securities or capital gains arising from their transfer.

115AD (1) Whether the total income of a Foreign Institutional Investor includes- 1. Income [other than income by way of dividends referred to in Section 115-)] received in respect of securities (other than unit referred to in Section 115AB); or] (b) Income by way of short-term or long-term capital gains arising from the transfer of such securities.

(2) Where the gross total income of the Foreign Institutional Investor- 1. consists only of income in respect of securities referred to in Clause (a) of Sub-section (1), no deduction shall be allowed to it under Sections 28 to 44C or Clause (i) or Clause (iii) of Section 57 or under chapter VI-A; 2. includes any income referred to in Clause (a) or Clause (b) of Sub-section (1), the gross total income shall be reproduced by the amount of such income and the deduction under chapter VI-A shall be allowed as if the gross total income as so reduced, where the gross total income of the Foreign Institutional Investor.

It may be seen that Clause (a) of Sub-section

(1) of Section 115AD of the Act, speaks of income received in respect of securities; from the operation of such income is excluded the income by way of dividends referred to in Section 115-O and from the operation of securities is excluded unit referred to in Section 115AB. The expression 'Income received in respect of securities' in Clause (a) connotes the income therefrom when the securities held by a FII are intact, e.g. dividends, interest etc. like fruits from a tree or a rent from an immovable property. The term 'income' employed therein, having regard to the context, can, by no stretch of imagination, be assumed as income arising from the transfer of such securities for the simple reason that such type of income is referred to in Clause (b) where the income is specified as being by way of short-term and long term capital gains arising from the transfer of such securities. Clause (a) of Sub-section

(2) is called in aid to support the contention that income in Clause (a) of Sub-section

(1) includes business income also, and it is argued that otherwise there is no reason why Sections 28 to 44C of the Act, the provisions relating to computation of 'profits and gains of business', should be excluded. We are not persuaded to accede to the contention of the learned Counsel. We have pointed out above that income in respect of securities, referred to in Clause (a) of Sub-section(1) of Section 115AD, refers to income in the nature of dividends, interest income of debentures and the like. For the purpose of realizing such income, an investor / a FII would naturally engage staff and incur expenditure by way of salaries of the staff etc.; incur expenditure in obtaining loan, pay interest thereon, or incur expenditure of like nature. In our view it is against such deductions that the Parliament guarded against by providing in Clause (a) of Sub-section

(2) of Section 115AD of the Act stating that no deduction shall be allowed in computing income in respect of securities referred to Clause (a) of Sub-section (1). If we read Section 115AD in conjunction with the regulations 12(3) of SEBI Regulations whereunder a sub-account of FII is registered as FII for the limited purpose of deriving benefit under Section 115AD, it becomes clear that this is for

the purpose of deriving the benefit of reduced rates of tax.

The circumstances and the framework of the plethora of legislative provisions unmistakably point out that a FII is not registered for carrying on trade in securities; it can only invest in securities for the purpose of earning income by way of dividends and interest and realizing capital gains on their transfer. Indeed to the same effect is the finding of the Authority in the case of General Electric Pension Trust, in re14. The following observation in that case is material: So far as the nature of the income of the applicant is concerned, it is no doubt true that the provisions of the FII investors scheme under both the old guidelines and the amended guidelines suggest that the investment in shares would be to acquire capital assets, the requirement of Section 18 of the FII's regulations also speaks of realization of capital gains of investment from the corpus.

Section 115AD - a special provision in the Act- provides special rates for taxation of short-term capital gains as well as long-term gains.

In the light of the above discussion, we are unable to countenance plea of the applicant that trading in securities is not prohibited under any Act or Regulation.

We have referred to above the contentions and the counter-contentions of the parties. Now the contention; what! if there is prohibition for trading in securities; the nature of transactions constitutes trading and therefore the income therefrom should be treated as profits of illegal business. Though this is an argument in despair, we shall have to see whether the first step - purchase of the shares -was not taken as, or in the course of, a trading transactions. In our view it will be preposterous to impute an intention to FIIs, who responded to the offer of investment in securities in response to the guidelines, got themselves registered under the SEBI Regulations and undertook to abide by those regulations that they would, in the very first step itself, have intended to violate all the legislative requirements which provided them the opportunity to enter the capital market in India.

That the FIIs could not have intended to trade in the first step of purchase of shares, is also strengthened by the fact that in the income tax returns filed by

many of them, in consonance with the above legislative provisions, they have shown their income as capital gains.

For the sake of brevity we have mentioned, in Annexure A to this ruling, how the applicants treated the income from the investments in Indian securities. From the above survey of the legislative provisions, it has been concluded that the scheme was meant for the FIIs to invest in securities in Indian companies for the purpose of earning income by way of dividends, interest etc and realizing capital gains on transfer of such securities and indeed they so acted in the first few years and that the first step was not taken in the course of trading transactions.

We shall revert to the aforementioned principles. The first principle requires us to ascertaining whether the purchase of shares by a FII in exercise of the power in the Memorandum of Association/Trust Deed was as stock-in-trade as the mere existence of the power to purchase and sell shares will not by itself be decisive of the nature of transaction. We have to verify as to how the shares were valued/held in the books of accounts i.e. whether they were valued as stock-in-trade at the end of the financial year for the purpose of arriving at business income or held as investment in capital assets. The second principle furnishes a guide for determining the nature of transaction by verifying whether there are substantial transactions, their magnitude etc. , maintenance of books of accounts and finding the ratio between purchases and sales. It will not be out of place to mention that Regulation 18 of SEBI Regulations enjoins upon every FII to keep and maintain books of accounts containing true and fair accounts relating to remittance of initial corpus of buying and selling and realizing capital gains on investments and accounts of remittance to India for investment In India and realizing capital gains on investment from such remittances. The third principle suggests that ordinarily purchases and sales of shares with the motive of realizing profit would lead to inference of trade/adventure in the nature of trade; where the object of the investment in shares of companies is to derive income by way of dividends etc., the transactions of purchases and sales of shares would yield capital gains and not business profits.

We have to ascertain the facts and apply the principles discussed above in the light of the observations of the Supreme Court in CIT, Bombay v.H. Holck Larsen (Supra 5) i.e. looking at not the end of the transaction but at the first purchase to judge each case. We shall examine the facts of the cases before us. In these cases (except in Applications Nos. AAR/683/2006, AAR/712/2006, AAR/719/2006 and AAR/720/2006) the applicants have furnished particulars of transactions with the applications, under the caption, "A list of trades". The list contains purchases and sales in respect of Fund No. 339 which is said to relate to AAR/694/2006 - Fidelity Hastings Street Trust: Fidelity Discovery Fund. Pertaining to the year 2004 purchases of shares are in five companies which are noted at pages 107-109 and sales of shares in six companies are noted at pages 110-123. In regard to 2005 the purchases by the said fund relate to shares in two companies which are noted at page 124 and the sales transacted are noted from pages 125-133. The applicant, (in Paper Book-4), has submitted details of sales and purchases of shares of each trust for the period 2005-2006.

They are reproduced in Annexure 'B' to this ruling. Even on close scrutiny of the particulars mentioned in Annexure ' B' it has not been possible for us to co-relate the sales and purchases of shares. That apart, for the purpose of the application of the principles discussed above, we have no clue about of the maintenance of the accounts by the applicants. From the accounts we would have been in a position to ascertain whether the shares have been entered therein as stock-in-trade or capital assets. Under the principle of accountancy the stocks-in-trade have to be valued at the end of each year in the case of trading to arrive at the profits of the business whereas in the case of investment in capital assets the gains can be determined only on the sale of such assets. In the case of Fidelity Advisor Series VIII (Supra 3) the Authority while laying down the aforementioned principles, noted the criteria to determine the said question. In spite of being aware of this position and even though the applicants are required to maintain such accounts under the SEBI Regulations, copies of the accounts maintained by them are admittedly not filed before the Authority to verify whether the requirements of the first principle is satisfied. In the absence of accounts we cannot but draw an adverse inference against the applicant, namely, had the accounts been produced before us they would have shown that the securities were not treated as stocks-in-trade but were

treated as capital assets and that the investments in securities were for purpose of realizing capital gains.

The ratio of sales and purchases are also not noted with reference to each applicant. The above discussion of the press note containing guidelines and various other provisions of different Acts and Regulations, at the least, raises a strong presumption that the transactions of purchases and sales of shares in Indian companies by the applicant are for realizing capital gains, which could have been rebutted by the applicant by producing all relevant records including accounts. It has to be borne in mind that the transactions of sales and purchases as stock-in-trade is a fact known to the applicant but it failed to produce necessary records including the accounts to satisfy the Authority that transaction is nothing but trading. In CIT v. Associated Industrial Development Co (P) Ltd (supra 11) the Hon'ble Supreme Court held thus: 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 who holds the shares and it 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.

In that case the assessee company acted as managing agents of various companies. The assessee claimed that the profit was capital gains and not income in its hands. The Tribunal held that in view of multiplicity of the transactions over the years, the assessee ceased to be an investor and had become a dealer though it dealt only in shares of managed companies. On reference the High Court upheld the findings of the Tribunal. On an appeal by the Revenue the Hon ble Supreme Court reversed the decision of this High Court making the above noted observations.

Even assuming for the sake of argument that it is open to the applicant to trade in securities the material placed on record does not support the claim that the applicant ever intended or indeed has done any trading in securities in India. We are, therefore, constrained to hold that the facts as disclosed and the material placed before the Authority do not help us to determine the criteria and therefore,

we are unhesitatingly led to the conclusion that the transactions are only in the nature of investment in capital assets to earn capital gains.

Application No. AAR/733/2006 relates to Matthews India Fund. Attachment 7 is the list of purchases of shares in various Indian companies (pages 88 to 95); at page 96 sales and purchases in two companies are noted.

From the perusal of the same it is not clear as to how the purchase and sales of shares were transacted in US Dollars if the transactions were conducted in the Stock Exchange of India. In all other respects this application also suffers from the same deficiency of not producing of the accounts and other relevant particulars to show that the transactions were in the nature of trade in securities. Therefore, the same result will also follow in this case also.

In XYZ/ABC, Equity Fund (Supra 4) the then learned Chairman dealt with a similar question and observed that there was little doubt that the purchase of shares of the company in India was part of the Company's business operation. On that basis it was ruled that the income from the sale of shares would have to be treated as trading profit as and when the shares were sold. In Fidelity Advisor Series VIII, USA (Supra 3) one of the questions which the Authority considered was, whether the income of portfolio companies arising from the sale of portfolio investments in India would be treated as business income. Taking the view that the question is a mixed question of law and facts and has to be decided on the facts of the case, the Authority referred to Raja Bahadur Visheshwara Singh & Others (supra 6), Dalhousie Investment Trust Co. Ltd. (Supra 7), CIT v. Sulej Cotton Mills supply Agency Ltd. (Supra 8) and the above said ruling in the XYZ/ABC Equity Ltd. (Supra 4), among others and ruled that the applicant held shares as business assets and profit from the purchase and sales of those shares were in the nature of business income.

In Morgan Stanley (Supra 2) the applicant was a company incorporated in UK and was a non-resident in India. It invested in exchange trade derivatives contracts. It was carrying on business in derivatives in other countries. To expand its business in various trading operation, it had also invested in India after obtaining permission of the Reserve Bank of India. While considering the question whether the income

derived by the applicant from trading in exchange traded derivatives instrument in India, would be taxable in India having regard to the provisions of the Double Taxation Avoidance Agreement, the incidental question that arose was whether the income arising to the applicant from the transaction was classifiable as capital gains or business profits. The contention of the revenue was that it was capital gains and not profits of business. It was noted that the life of the exchange derivatives was less than three months and they could not be held as capital assets for any length of time. Having considered the definition of capital asset and noting that the stock-in-trade is excluded from the definition of capital assets and the facts of the case in the light of the principles noted above, it was held that the applicant was having business income. That case is clearly distinguishable on its facts. CIT, Bombay v. H. Holck Larsen (Supra 5) was not referred to and the test laid down thereon was not applied. Further the question being essentially "mixed question of law and fact" on the facts and the records that were placed before the Authority in those cases, the conclusion of the Authority was recorded in them. Therefore, those judgements cannot be an authority to hold that in this case also the income arising from purchase and sale of shares is a business profits.

9. Questions Nos. (1) to (4) are common in all the applications of US Group. Question No. 1 is the main question. Question nos. (2) to (4) are consequential and need to be answered only if the Authority were to come to the conclusion that the transactions of sales and purchases of shares in Indian Companies by the applicants amount to trading and the income arising therefrom would be taxable as profits and gains of business or profession. In as much as we have held above that the aforementioned transactions of purchases and sales in securities were investment in capital assets leading to realizing of capital gains, question nos. (2) to (4) need not be answered.

In Canada Group of cases also questions no. (1) is common in all the applications and is the main question. Question nos. (2) and (3) are consequential. They need to be answered only if the Authority were to come to the conclusion that the transactions of sales and purchases of shares in Indian Companies by the applicants amount to the trading and the income arising therefrom would be taxable as profits and gains of business or profession. In as much as we have held

above that the aforementioned transactions of purchases and sales in securities were investment in capital assets leading to realizing of capital gains, question nos. (2) and (3) need not be answered.

In Matthews India Fund also question no. (1) is the main question and question nos. (2) and (3) are consequential as in US Group of cases.

Question no. (4) is given up by the applicant.

In view of the findings recorded by us above, it is unnecessary to discuss the other contentions urged by the parties because they related to consequential questions.

on question no.:(1) on the facts and in the circumstances of the case, the profits arising to the applicants from the sale of portfolio investments in India could not be treated as business income of the applicant.

question nos: (2) to(4) these are consequential to the ruling pronounced on the first question, so in view of that ruling, these questions do not survive.

question no.: (1) on the facts and in the circumstances of the case, the profits arising to the applicants from the sale of portfolio investments in India could not be treated as business income of the applicant.

question nos.:(2) and (3) these are consequential to the ruling pronounced on the first question, so in view of that ruling, these questions do not survive.

question no.: (1) on the facts and in the circumstances of the case, the profits arising to the applicant from the sale of portfolio investments in India could not be treated as business income of the applicant.

question nos.:(2) and(3) these are consequential to the ruling pronounced on the first question, so in view of that ruling, these questions do not survive.

Pronounced in the open court of the Authority on this 8th day of January, 2007.

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