GLOBAL TAX ADVISORY SERVICES

JUNE 2007

EY Tax Alert

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This Alert summarises the contents of Circular No 4/2007 dated June 15, 2007 issued by the Central Board of Direct Taxes on the tests for making a distinction between shares held as stock-in-trade and shares held as investment.

BACKGROUND

The Central Board of Direct Taxes (CBDT) has issued Circular No 4/2007 dated June 15, 2007 (Circular) on the tests for making a distinction between shares held as stock-in-trade and shares held as investment. The CBDT, through Instruction No. 1827, dated August 31, 1989 had earlier brought to the notice of the Assessing Officers that there is a distinction between shares held as investment (capital asset) and shares held as stock-in-trade (trading asset). The Circular updates and supplements Instruction No. 1827 dated August 31, 1989 for the information of taxpayers as well as to provide guidance to the Assessing Officers.

This alert summarises the contents of the Circular and the likely impact on taxpayers.

PRINCIPLES OUTLINED IN THE CIRCULAR

The Circular outlines certain principles for making the distinction between shares held as stock-in-trade and shares held as investment. In outlining the aforesaid principles the CBDT has placed reliance on decisions of the Supreme Court in the case of *CIT vs. Associated Industrial Development Company Pvt Ltd (82 ITR 586) and CIT v H Holck Larsen (160 ITR 67)* and also the Ruling by the Authority for Advance Rulings (AAR) in the case of *Fidelity Northstar Fund vs. DIT (288 ITR 641) In Re.*

The principles outlined in the circular are summarised below:

- Existence of the power to purchase and sell shares in the memorandum of association of a company is not decisive of the nature of the transaction. Verification of how the shares were valued/ held in the books of accounts, i.e. whether they were valued as stock-in-trade or held as investment in capital assets would serve as a good guide in making a distinction;

- 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/trust 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 gains and not business income.

The Circular also states that no single principle would be decisive and the total effect of all the principles should be considered in determining whether the shares held by taxpayers are held as stock-in-trade or as investments. The Circular recognises that it is possible for a taxpayer to have two portfolios, i.e. an investment portfolio comprising of securities which are to be treated as capital assets and a trading portfolio comprising of stock-in-trade which are to be treated as trading assets.

IMPLICATIONS

Appropriate characterization of income arising to a taxpayer from transactions involving sale of shares is important as it determines whether income should be taxed as "business profits" or as "capital gains" and the rate at which such income should be taxed.

While business profits are taxed at the basic rate of 30 per cent (for individuals and domestic companies) and at 40 per cent (for foreign companies), most types of capital gains are eligible for taxation at a lower rate. Capital gains on shares held for 12 months or more (long term capital gains) are taxed at a basic rate of 20%. Gains arising from sale of listed shares (i.e. shares

listed on an Indian stock exchange) that are held for less than 12 months (short term capital gains) are taxed at the basic rate of 10 per cent, while long term gains arising from sale of listed shares are exempt from tax. Further, the domestic tax law also provides for a preferential tax rate for capital gains arising to registered Foreign Institutional Investors (FIIs).

The likely impact of the Circular for FIIs would depend upon their eligibility for benefits under a Double Taxation Avoidance Agreement (DTAA) and the provisions of the applicable DTAA.

- In case of FIIs eligible for benefits under the India-Mauritius DTAA (or a comparable DTAA), classification of income as capital gains would not result in taxation in India, while classification as business profits would result in taxation only if the FII has a PE in India to which the income is attributable.

- In case of FIIs eligible for benefits under other DTAAs, a capital gains classification would generally result in taxation in India while a business profits classification could avoid taxation in India unless the FII has a PE in India to which the income is attributable.

- In case of FIIs not eligible for benefits under a DTAA, income from sale of shares of an Indian company, irrespective of classification, would generally be taxable in India under the domestic tax law.

CONCLUSION

FIIs and other investors who regularly engage in trading of shares and securities would need to assess the impact of the Circular on their activities to determine the appropriate classification of income and the rate at which the income would be taxed. The Circular does not provide a bright-line test for making the appropriate classification; but merely provides certain guiding principles which may be subject to conflicting interpretations.

In case of a business profits classification, FIIs eligible for benefits under a DTAA may not generally be taxable in India. However, Indian Tax Authorities could attempt to review their activities to determine if there exists a PE in India and whether the gains can be attributable to that PE. Limited guidance in the Indian context on income attribution to a PE – especially in the case of financial institution PEs – could be a concern.

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