

Investment through portfolio management services not a business activity; investment in shares using borrowed funds not relevant for characterisation of income

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In brief

The Karnataka High Court has upheld an order passed by the Bangalore Income-tax Appellate Tribunal (Tribunal) by concluding that:

- Profit from investments made through professionally managed Portfolio Management Services (PMS) did not mean that the taxpayer was conducting a 'business' of investment in shares; and
- The Income-tax Act, 1961 (the Act) did not prohibit the taxpayer from making investments in capital assets using borrowed funds. Hence, the said fact was not relevant when determining the characterisation of income earned from the transfer of shares.

In detail

Facts

- The taxpayer¹, engaged in the business of finance and films, had invested in shares through a PMS. The taxpayer had borrowed a sum for making these investments.
- In the taxpayer's return of income, gains arising from the transfer of shares were offered to tax as 'capital gains'.
- In view of the frequency of the transactions, the Tax

Officer (TO) characterised the exit gains as business income.

- On further appeal, the Commissioner of Income-tax (Appeals) and the Bangalore Tribunal decided in favour of the taxpayer.

Issue before HC

- Whether investments made through a portfolio manager implied that the taxpayer was serious about earning income through strategic/ planned transactions, and was thus conducting business?

- Whether borrowing money for dealing in shares justifies characterisation of the transactions as trading activity?

HC ruling

- The High Court relied on the decision of the Delhi High Court in the case of Radials International² to hold that the investment made by the taxpayer through a PMS which may deal with the taxpayer's shares in order to derive maximum profits could not be regarded as the taxpayer's business. The

¹ CIT v. Kapur Investments Pvt Ltd [TS-318-HC-2015(KAR)]

² Radials International v. ACIT [2014] 367 ITR 1 (Del)

same would only be a case of a more careful and prudent mode of investment. Thus, the exit gains from transfer of shares were taxed as capital gains.

- As regards the second issue, the High Court held that the Act did not restrict the taxpayer from investing in capital assets by using borrowed funds. Hence, use of borrowed money could not be the determining factor for characterisation of the income.
- Furthermore, the High Court held that the findings arrived at by the Tribunal were in conformity with the guidelines issued by the Central Board of Direct Taxes (CBDT) in its Circular No. 4, dated 15 June 2007.

The takeaways

The High Court has laid down an important principle, that borrowing by the taxpayer is not relevant for determining the characterisation of income from the transfer of securities.

As per the principles laid down by the CBDT in its Circular no. 4 dated 15 June 2007 and various conflicting judicial precedents, for determining the characterisation of income, the total effect of all the principles need to be considered. This latest decision of the High Court may serve as a guiding principle, but the facts and circumstances of each specific case should be considered to analyse the total effect of all the principles discussed in Circular no. 4 dated 15 June 2007.

Let's talk

For a deeper discussion of how this issue might affect your business, please contact:

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