

# Sharing insights

News Alert  
9 December 2013



## Income of Foreign Institutional Investors from dealing in derivatives taxable as capital gains and not business income

### In brief

In its recent ruling<sup>1</sup>, the Mumbai bench of the Income Tax Appellate Tribunal (the Tribunal) held that income earned by a Foreign Institutional Investor ('FII') from transactions in derivatives is in the nature of capital gains and not business profits.

### Facts

- The assesseees are sub-accounts of an Australian based entity, Platinum Investment Management Ltd. which is registered as an FII with the Securities and Exchange Board of India (SEBI).
- The assesseees are governed by the SEBI FII Regulations, 1995. Their activities involved purchase and sale of securities in India and trading in derivatives.
- During the year under consideration, the assesseees had earned capital gains from transactions in shares and incurred losses from transactions in index derivatives. The assesseees claimed losses arising from index derivative trading transactions as short term capital losses and netted off such losses against the

<sup>1</sup> Platinum Asset Management Ltd A/c Platinum Asia Fund v. DDIT (ITA No. 2787/M/2012) & Platinum Asset Management Ltd A/c Platinum International Brand Fund v. DDIT (ITA No. 2788/M/2012)

capital gains earned on transactions in shares. The balance losses were carried forward in the return of income.

- The Assessing Officer ('AO') held that loss arising from index derivative transactions was 'business loss' assessable under the head 'income from business or profession' rather than under 'capital loss', as claimed by the assessee.
- The Commissioner of Income-tax (Appeals) ['CIT (A)'] agreed with the AO and held that in the absence of a 'Business Connection' or a 'Permanent Establishment' in India, in accordance with the India-Australia tax treaty, the business loss arising on transfer of derivatives could not be determined, and hence was not allowable as set-off against the capital gains arising on transfer of shares in India.

### Issue

- Whether losses incurred by an FII from transactions in derivatives are to be treated as capital loss or business loss.

### Revenue's contentions

- Reliance was placed on the decision of the Honourable Bombay High Court in the case of Bharat R. Ruia<sup>2</sup> to contend that a transaction in respect of derivatives was a speculative transaction.
- It was further submitted that prior to an amendment made by Finance Act, 2005 in section 43(5) of the Income tax Act, 1961 ('the Act'), trading in derivatives was a speculative transaction. After the insertion of clause (d) to section 43(5) by Finance Act, 2005 w.e.f. 1.4.2006, a transaction involving derivatives at a recognized Stock Exchange was a business transaction and could not be considered as an investment.

*(It seems that the revenue did not contend why business loss cannot be set-off against income from capital gains).*

### Assessee's contentions

- Income earned by FIIs from transactions in derivatives was in the nature of capital gains/ losses.
- The issue at hand was favourably covered by this Tribunal's decision in the case of Platinum Investment Management Ltd. A/c Platinum International Fund<sup>3</sup>.
- The decision in the case of Bharat R. Ruia<sup>2</sup> was not applicable to the facts of the case as the assessee in the present case were FIIs registered with SEBI.
- FIIs are not allowed to do business in the securities market and 'derivative' is a security under the Securities Contract (Regulation) Act, 1956.

### Tribunal's ruling

- The decision in the case of Bharat R. Ruia<sup>2</sup> was not relevant to the facts of the case.
- The issue was squarely covered by the earlier decision of the Tribunal in the case of Platinum Investment Management Ltd. A/c Platinum International Fund<sup>3</sup> which was decided by considering the earlier order of the co-ordinate Bench in the case of LG Asian Plus Ltd.<sup>4</sup>.
- The Tribunal reiterated the following observations made in the case of LG Asian Plus Ltd.<sup>4</sup> and Platinum Investment Management Ltd. A/c Platinum International Fund<sup>3</sup>:

<sup>2</sup> CIT v. Bharat R. Ruia [2011] 337 ITR 452 (Bom)

<sup>3</sup> DDIT v. Platinum Investment Management Ltd A/c Platinum International Fund [2013] 33 taxmann.com 298 (Mumbai-Trib)

<sup>4</sup> LG Asian Plus Ltd v. ADIT [2011] 46 SOT 159 (Mumbai-Trib)

- The expression FII had been defined in section 115AD of the Act to mean such investors as the Central Government may, by a notification in the Official Gazette, specify as such. FIIs registered with SEBI will automatically be notified by the Central Government for the purposes of section 115AD of the Act.
- On close scrutiny of the SEBI FII Regulations, 1995, together with section 115AD of the Act seen in light of the Memorandum explaining these provisions of the Finance Bill, 1993, it was clear that an FII was allowed to only invest in the ‘securities’ and was not allowed by the Central Government to do business in the securities. Furthermore, the income from securities either from their retention or from their transfer was to be taxed in accordance with section 115AD of the Act alone, which referred to income by way of short term and long term capital gains.
- It was abundantly clear from the Press Note<sup>5</sup> issued by Ministry of Finance that FIIs had been considered as ‘investors’ (and not traders). Moreover, income from transfer of securities had been viewed as chargeable to tax under the head ‘capital gain’, as long-term or short-term capital gain depending upon the period for which such securities were held.
- Referring to Section 115AD(2)(a) of the Act, the Tribunal held that it was inapplicable in the current case, as the section pertained to non-permissibility of expenses under sections 28 to 44C or section 57 or Chapter VI A of the Act, from the income earned on securities retained by the FII. Furthermore, as regards Section 115AD(2)(b), a plain reading made it manifest that the gross total income of a FII may include income other than income received in respect of securities or from the transfer of such securities. The Tribunal held that the rationale behind section 115AD(2)(b) was that the income of an FII, other than that arising from the holding or transfer of securities (such as interest), should find its place in the total income, and the deductions under Chapter VI-A should be allowed by considering gross total income net of income received in respect of securities or arising from the transfer of such securities.
- Income arising to a FII from transfer of ‘securities’ as specified in Explanation (b) to section 115AD could only be considered as short term or long term capital gain and not as ‘business income’. As derivatives had been included in the definition of securities for the purpose of section 115AD, the income from derivatives should also be considered as short-term or long-term capital gain, depending upon their period of holding.
- Section 115AD was a special provision, and special provisions overrode the general provisions. If a particular item of income was covered by a special section, it would be strictly governed by the prescription of that relevant section alone. It was seen that income arising from the transfer of securities of the FIIs had been included under section 115AD, to be categorised as short-term or long-term capital gains depending upon the period of holding. In such a situation, it was impermissible to consider income of a FII as falling under the head ‘profits and gains of business or profession’.
- Section 43(5) of the Act, defining a speculative transaction, was relevant only in the context of income under the head ‘profits and gains of business or profession’, and had no application to FIIs in respect of securities, the income from whose transfer was considered as short-term or long-term capital gains.

## Conclusion

- This is the third successive ruling from the Mumbai bench of the Tribunal holding that the income of FIIs by way of transactions in derivatives is in the nature of capital gains. The reasoning given in the ruling would also apply to all FIIs investing in other securities.

<sup>5</sup> F No. 5(13) SE/91-FIV dated 24.03.1994 issued by Ministry of Finance, Department of Economic Affairs (Investment Division), New Delhi

## About PwC

PwC helps organisations and individuals create the value they're looking for. We're a network of firms in 157 countries with more than 184,000 people who are committed to delivering quality in Assurance, Tax and Advisory services.

PwC India refers to the network of PwC firms in India, having offices in: Ahmedabad, Bangalore, Chennai, Delhi NCR, Hyderabad, Kolkata, Mumbai and Pune. For more information about PwC India's service offerings, please visit [www.pwc.in](http://www.pwc.in).

\*PwC refers to PwC India and may sometimes refer to the PwC network. Each member firm is a separate legal entity. Please see [www.pwc.com/structure](http://www.pwc.com/structure) for further details. Tell us what matters to you and find out more by visiting us at [www.pwc.in](http://www.pwc.in).



## Our offices

<p><b>Ahmedabad</b> President Plaza, 1st Floor Plot No 36 Opp Muktidham Derasar Thaltej Cross Road, SG Highway Ahmedabad, Gujarat 380054 Phone +91-79 3091 7000</p>	<p><b>Bangalore</b> 6th Floor, Millenia Tower 'D' 1 &amp; 2, Murphy Road, Ulsoor, Bangalore 560 008 Phone +91-80 4079 7000</p>	<p><b>Chennai</b> 8th Floor, Prestige Palladium Bayan 129-140 Greams Road, Chennai 600 006, India Phone +91 44 4228 5000</p>	<p><b>Hyderabad</b> #8-2-293/82/A/113A Road no. 36, Jubilee Hills, Hyderabad 500 034, Andhra Pradesh Phone +91-40 6624 6600</p>	<p><b>Kolkata</b> 56 &amp; 57, Block DN. Ground Floor, A- Wing Sector - V, Salt Lake. Kolkata - 700 091, West Bengal, India Telephone: +91-033 - 2357 9101/4400 1111 Fax: (91) 033 - 2357 2754</p>
<p><b>Mumbai</b> PwC House, Plot No. 18A, Guru Nanak Road - (Station Road), Bandra (West), Mumbai - 400 050 Phone +91-22 6689 1000</p>	<p><b>Gurgaon</b> Building No. 10, Tower - C 17th &amp; 18th Floor, DLF Cyber City, Gurgaon Haryana -122002 Phone : +91-124 330 6000</p>	<p><b>Pune</b> GF-02, Tower C, Panchshil Tech Park, Don Bosco School Road, Yerwada, Pune - 411 006 Phone +91-20 4100 4444</p>	<p>For more information contact us at, <a href="mailto:pwctr.knowledgemanagement@in.pwc.com">pwctr.knowledgemanagement@in.pwc.com</a></p>	

For private circulation only

This publication has been prepared for general guidance on matters of interest only, and does not constitute professional advice. You should not act upon the information contained in this publication without obtaining specific professional advice. No representation or warranty (express or implied) is given as to the accuracy or completeness of the information contained in this publication, and, to the extent permitted by law, PwCPL, its members, employees and agents accept no liability, and disclaim all responsibility, for the consequences of you or anyone else acting, or refraining to act, in reliance on the information contained in this publication or for any decision based on it. Without prior permission of PwCPL, this publication may not be quoted in whole or in part or otherwise referred to in any documents.

©2013 PricewaterhouseCoopers. All rights reserved. "PwC", a registered trademark, refers to PricewaterhouseCoopers Private Limited (a limited company in India) or, as the context requires, other member firms of PricewaterhouseCoopers International Limited, each of which is a separate and independent legal entity.