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Tax Alert

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Transactions in Shares through a PMS - Business Income or Capital Gains?

Time and again there has been a debate on whether transactions of purchase and sale of shares are to be considered as business transactions or investment transactions. The significance of this distinction is that sale of investments gives rise to capital gains/loss while sale of stock in trade gives rise to business income. The former is eligible for several concessions for tax purposes in India as compared to the latter. The tax authorities are therefore, generally taking a view in a large number of cases, where the volume or frequency of transactions is large, that the same should be considered as a business of trading in shares instead of as investment activity. On the other hand, the concerned tax payer would naturally want to get the gains from such transactions to be treated as capital gains and thereby pay lesser or no tax.

There are a plethora of appellate and judicial decisions on this issue which are fact-specific in nature. A recent decision of the Pune Bench of the Income-tax Appellate Tribunal (ITAT) in the cases of KRA Holding & Trading Pvt. Ltd., Pune Vs DCIT (ITA 500/PN/08) and ARA Trading and Investments Pvt. Ltd., Pune Vs DCIT (ITA No. 499/PN/2008) has brought out certain interesting arguments that were put forward by the respective tax payers in order to defend their claim that investments made under a Portfolio Management Scheme (PMS) did not constitute a business of trading in shares despite the large volume and frequent churning of the portfolio. This tax alert brings to you the highlights of the decision of the ITAT. It may be noted that since the facts in both appeals were identical, the ITAT has, for the sake of convenience, referred only to facts relating to KRA Holding & Trading Pvt Ltd and has mentioned in the order that the decision would hold good for both appeals.

Facts in the case of KRA Holding & Trading Pvt Ltd:

The assessee is an investment company holding 18% shares of Thermax Ltd from 1995 to 2004 and from which it had earned dividend income of Rs. 180 Million. From those amounts, the company had invested in shares acquired from the secondary market. For acquiring

these shares, the company had entrusted substantial funds to five portfolio managers. The portfolio managers were granted sole discretion in respect of making investments. However, they were not allowed to enter into speculative transactions or to settle any transaction without giving/taking delivery of the shares. Out of the five portfolio managers, most of the transactions were carried out only through one of them. In its books of account as well as in its tax return, the company treated the gains/losses from its various portfolios as capital gains/losses and offered its income for tax accordingly.

Dispute with the tax department

The Assessing Officer (AO) and the first appellate authority–Commissioner of Income-tax (Appeals) (CIT(A)) were of the view that the assessee was a dealer in shares and thus, the income from the various transactions was to be taxed under the head Profit and Gains of Business and Profession and not under the head Capital Gains.

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Revenue's Contention before the ITAT

1. The quantity of shares sold during the year was much more than the opening stock, so the sales for the year under consideration were much more, both in terms of quantity and value as compared to the preceding year.

2. Majority (80%) of the transactions (which were carried out through one of the portfolio managers) were short term transactions and were carried out on a daily and systematic basis.

3. The fees paid to one of the Portfolio Managers were loaded onto the purchase price and thus the profit was calculated after deducting the fees as in case of normal calculation of business profits.

4. Frequent purchases and sales on a large scale regularly in an organised and systematic manner clearly demonstrated that the activity was an adventure in the nature of trade.

5. The company had claimed several expenses like telephone charges, bank charges etc. as a deduction by way of debit to the Profit and Loss Account and this would happen only in case of a business.

Assessee's Contention:

1. The transactions were carried out by professional portfolio managers and the assessee itself has only played a passive role in the same.

2. Out of the total sale consideration, about 56% came from sale of shares purchased in the earlier year and hence the holding period of such shares was more than one year. So by and large, such transactions were not short term transactions.

3. The entire investment in the portfolios was made out of earlier year's accumulated corpus which was built up from the dividend income from the shares held in Thermax Ltd. There was no borrowing of funds.

4. There was a distinction in the shares which were held by way of investments and those held by way of stock in trade which was visible from the accounts of the company wherein separate classification of 'investments' & 'stock in trade' was made. Further the investments were not valued at the lower of cost and market price (as is generally done in case of stock in trade) but were valued at cost.

5. The objective of appointing portfolio managers was to preserve the capital and to achieve growth in capital which was factually brought out in the terms of the arrangement with them.

6. The volume of transactions was immaterial and should not be taken to decide the issue as a prudent investor cannot stand static and remain insensitive to the market. Therefore, with a view to boost the value of its investments in the capital market, the portfolio manager does some times transfer the holding with sole purpose to predominantly act as an investor.

The ITAT held in favour of the Assessee and in both appeals, it has been decided that the transactions of purchase and sale of shares by the assessee through the various portfolio managers were to be classified as investment activity and that the income arising from such transactions were to be taxed under the head Capital Gains and not Profits and Gains of Business or Profession.

The Decision of the ITAT

1. The predominant intention of the assessee company was to hold the shares as investments and not as stock in trade. This intention is brought out by the following facts:

   a. The decision of whether a transaction of sale or purchase of shares is a trading or business transaction is a mixed question of facts and law. As such the intention of the assessee was to be seen which, in the present case, was an activity of wealth maximisation rather than profit maximisation.

   b. Most of the shares were held for over one year on an average basis and large investments were on delivery basis and not on speculative basis. Therefore, the predominant objective was to create wealth on a long term basis and to earn maximum profit out of these investments;

   c. The assessee had not traded in shares and was entirely dependant upon its portfolio managers and hence could not be termed as a 'dealer' in shares.

   d. Though there were frequent sale and purchase transactions, the investment made was out of own corpus generated through dividend income in earlier years. Thus, there was no necessity to borrow funds as is generally done for a regular business activity.

   e. A stock in trade is generally valued at lower of cost and market value. However, in the instant case, the assessee had valued the investment at cost only as against the prevalent method adopted by a business concern which was indicative of its position as an investor.

   f. The assessee was not directly involved in the trading activity, therefore its holding was nothing but an investment and the intention was only to maximise the value of its wealth in the shape of shares and such an activity

cannot be held as a profit seeking activity of an investor.

g. Per AS 13, investments are assets held for capital appreciation and other allied benefits whereas if the investment is in the nature of readily realisable assets and intended to be for a short term, it is treated as stock in trade. In line with this, the assessee had specifically classified the shares under the head “investment” and not as “stock in trade” in its books of accounts.

2. Accretion to capital does not become income merely because the original capital was invested in the expectation that it would, in due course of time, rise in value.

Based on the above, the ITAT held in favour of the Assessee and in both appeals, it has been decided that the transactions of purchase and sale of shares by the assessee through the various portfolio managers were to be classified as investment activity and that the income arising from such transactions were to be taxed under the head Capital Gains and not Profits and Gains of Business or Profession.

SKP Comments

As mentioned at the beginning, such disputes are fact specific and each case would need to be decided on a case to case basis. However, in a large number of cases where the investors have appointed professional portfolio managers to handle their investments, this decision would be very useful as this is probably the first such case to be decided where the tax officer has held PMS transactions to be business transactions and where the ITAT has, by way of a speaking and detailed order, rejected such a stand ■

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