

Delhi ITAT rules income from transactions of dealing in shares through Portfolio Management Services is business income

Executive Summary

This tax alert summarizes the recent significant ruling of the Delhi Income Tax Appellate Tribunal (ITAT) in the case of **Radials International** (the Taxpayer)¹, on an issue whether income earned through transactions routed through Portfolio Management Services (PMS) is in nature of business income or Capital Gains. The Taxpayer, engaged in the business of providing technical, marketing and maintenance services for earth-movers tyres and trading in tyres, had deposited money under PMS. In return of income, the Taxpayer showed the income from transactions in shares through PMS as Short Term Capital Gains. The Assessing Officer (AO) assessed the income as business income on the ground of frequency and volume of the transactions. On an appeal, the first appellate authority upheld the order of the AO. On further

appeal to the Income Tax Appellate Tribunal (ITAT), held, that to determine the nature of transaction, the real intent of the Taxpayer needs to be looked at. Though the transactions were delivery based and routed through PMS, the Taxpayer had deposited the amount with PMS to earn profit. Since the PMS agency had the discretion over the transactions, the Taxpayer cannot claim that shares were held as investments. Hence, the income was assessable under the head 'Income from Business and Profession'

Background

- Income from transactions in shares, when taxed as Short Term Capital Gains, attract concessional tax rate of 15% under section 111A of the Act. But if it is assessed as business income, the benefit of concessional rate is not available

- The Taxpayer is engaged in the business of providing technical, marketing and maintenance services for earth-movers tyres and trading in tyres
- It had deposited money under a contract with PMS agency for investing in shares for earning profits
- In its return of income, the Taxpayer had showed the income as short term capital gain and the shares were classified in the Balance Sheet under the head 'Investments'
- During the course of assessment, the AO observed that the Taxpayer had entered into numerous and frequent transactions of dealing in shares during the year and in almost all the transactions, the shares were held for short period of time. Hence, the AO treated the income as business income

¹ I.T.A No. 1368 (Del) of 2010

- On an appeal to the first appellate authority, it upheld the order of the AO on similar grounds
- Aggrieved by the order, the Taxpayer made an appeal before the ITAT

Taxpayer's contentions

- The amount deposited with PMS agencies were out of own surplus funds, the fact which is supportive of the investment motive
- It is not engaged in the business of share trading
- The transactions were delivery based
- The high volume of transactions, by itself, is not decisive as to nature of income
- Securities transactions Tax and brokerage had been paid on each transaction and the same had not been claimed as deduction in the return of income
- The income was earned in respect of shares acquired in the previous financial year wherein they were classified as investments and the classification was accepted by the Department. Therefore, Department's

position that the shares are stock-in-trade, is contrary to the rule of consistency

- The income should be assessed as short term capital gain eligible for the concessional rate of tax

Tax Authority's contentions

- The Portfolio manager is an agent of the Taxpayer
- When the transactions in shares are dealt through PMS agency, the discretion as to the shares and its holding period does not rest with taxpayer. Since the Taxpayer has no discretion, it cannot be said that he is holding the shares as investment
- The transactions are numerous and frequent, indicating that the shares were dealt with as stock-in-trade
- Since the PMS agencies held the shares as stock in trade, indirectly they were stock-in-trade of the Taxpayer too
- Hence, income from transactions carried out through PMS agencies are chargeable to tax under the head business as opposed to being charged to tax as Short Term Capital Gains

ITAT ruling

- From the definition of 'Portfolio Manager' as per SEBI Regulations, he acts as an agent of the investor, who devotes sufficient time in reshuffling the shares on behalf of the investor
- To know the nature of transaction, its real intent is to be looked into
- At the time of deposit of the amount under PMS, the intention of the Taxpayer was to maximize profit
- After depositing the money with PMS agency, the investment in securities is left to the choice of the portfolio manager. The individual does not have choice either regarding selecting the securities or the period of holding
- Since dealing in shares under PMS was not in the control of the Taxpayer, it cannot be said that the Taxpayer had invested with an intention to hold shares as investments
- The transactions were frequent and volumes were high
- Merely because the transactions are delivery based, it does not partake the character of investment

- The acceptance by the Department of classification of shares as 'Investments' in a particular financial year would not prevent it from reclassifying them as stock-in-trade in the subsequent year on appreciation of facts in the relevant year. The principles of *res judicata* is not applicable to income tax proceedings
- The transactions in units of mutual funds are not comparable with those carried through PMS agency, due to inherent difference between the respective schemes

Our comments

- This ITAT ruling demystifies a belief of a section of the taxpayers that income arising from transactions in shares and securities carried out under PMS is always eligible for concessional rate of tax applicable to Short Term Capital Gains
- The nature of income arising from dealings in shares and securities is essentially a question required to be resolved in the light of surrounding facts. No single test can be laid down to

determine the true nature of the transactions, though, indicative factors have been spelt out in the CBDT Circular² and in various High Court and ITAT rulings

- Merely because the shares were classified in the Balance Sheet as 'Investments' in previous financial year or that the income from share dealings in the earlier year(s) were taxed as 'Capital Gains', will not necessarily prevent the Revenue from taking a position that the income from sale of the shares is assessable under the 'Business' head, if in the facts of the case, the said position is sustainable
- In the present ruling, the ruling seems to have been influenced by the volume and frequency of the transactions and non discretionary nature of the PMS
- The law on classification of income as to Short Term Capital Gains or Business Income in the case of dealing in shares is evolving. The Mumbai Tribunal, in various cases, has ruled in favor of the Taxpayers. However, this ruling which

is in favor of the Revenue, needs careful consideration of the taxpayers while filing tax returns

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² Circular No. 4/ 2007 dated 15.06.2007

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