

The AAR rules that income arising to an FII from derivative transactions is 'Business income' and not liable to tax in India in the absence of permanent establishment ('PE') in India

Facts of the case

- The Royal Bank of Canada ('RBC') is a tax resident of Canada and is registered as a Foreign Institutional Investor ('FII') with the Securities and Exchange Board of India ('SEBI'). It undertakes transactions in futures and options ('derivative transactions') on Indian stock exchanges ('SE'). It also intends to undertake purchase / sale of equity shares or other tradable securities in near future ('equity transactions').
- RBC has a representative office in India which is engaged in preparatory and auxiliary activities relating to the core banking business, which does not / will not play any role in the aforesaid transactions of RBC.

Issues before the AAR

RBC had raised the following questions before the Authority for Advance Rulings ('AAR'):

- Whether the profits / losses from derivative and equity transactions are in the nature of 'Business income' under the provisions of the Income tax Act, 1961 (the 'Act') read with the double taxation avoidance agreement between India and Canada ('India-Canada tax treaty')?
- Whether the business income could be held to be not taxable in India since RBC does not have a PE in India as per the India-Canada tax treaty?

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RBC's contentions

- RBC contended that the derivative transactions undertaken were a part of its trading activity with no intention to hold on the derivatives on a long term basis and thus the income from such activity was in the nature of business income. Further, in the absence of a PE in India such income should not be taxable in India in accordance with Article 7 of the India-Canada tax treaty. Heavy reliance was placed on the case of Morgan Stanley and Co International Limited (272 ITR 416) where the AAR had upheld this view in relation to derivative contracts.
- Similarly, it contended that the equity transactions were also for the purpose of earning trading profits and should accordingly be characterized as 'business income'. Hence, the profits would not be taxable in India in absence of a PE in India.

Revenue's contentions

- Under SEBI and Foreign Exchange Management Act, 1999 ('FEMA') regulations, RBC is only allowed to make 'investments' in the capital market in India.
- The derivative transactions would amount to an investment activity and the income thereon would not be business income but capital gains which would be taxable in India under Section 115AD of the Act which is a self contained code applicable to the FIIs that contemplates income from dividend, interest and capital gains only.
- Thus, any income earned by an FII would be capital gains only, which is liable to be taxed in India.

Ruling

The AAR, based on the following observations, held that profits / losses from derivative transactions are in the nature of business income and shall not be taxable in India in absence of a PE as per Article 7 of the India-Canada tax treaty:

- The facts in the present case were similar to that in case of Morgan Stanley (supra) wherein it was ruled that income from exchange traded derivatives being short-term in nature was business income and was not taxable in India as per the provisions of Article 7 the India-UK tax treaty.
- Based on various judicial precedents, factors such as substantial nature of

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transactions, manner of maintaining the books of accounts, magnitude of shares purchased and sold and ratio between purchase and sales and the holdings are relevant to determine whether dealing in shares / securities should be treated as business income or capital gains.

- Since derivatives are non income yielding short-term instruments, they could only be held as stock-in-trade and not investments. Further, the manner of accounting derivatives in the books of accounts indicates that income from derivative transactions gives rise to business income and not capital gains.
- AAR's ruling in case of Fidelity North Star Fund (288 ITR 641) wherein it was held that income from purchase / sale of shares and securities by an FII are only in nature of capital gains and liable to be taxed in India could not be applied in the present case where derivative transactions are undertaken by RBC. In that case, the AAR had proceeded on the premise that trading in equity shares is not permitted under the Indian regulations.
- FEMA and SEBI regulations do not preclude FIIs from trading in exchange traded derivatives.
- Income from 'trading in securities' could be regarded as income 'in respect of securities' under Section 115AD(1)(a) of the Act. Such special provisions under the Act cannot be invoked by the tax authorities to deny benefit which is otherwise due to RBC under the treaty provisions.
- As regards the equity transactions, in the absence of actual facts, pattern of dealings, and the modus operandi, the AAR declined to give the ruling.

BMR comments and analysis

The AAR ruling assumes significance in view of reiteration of the principle that the income of the FIIs from derivative transactions is not taxable in India in the absence of a PE in India.

While this ruling is favorable for the FIIs with respect to income from exchange traded derivatives, characterization of income from dealing in shares is still not free from doubt. This will continue to remain an impediment in attracting FII's investments especially from countries other than Mauritius.

While the AAR has not dealt with the characterization of income from trading in

shares, it is noteworthy that they have clarified that even trading income is covered within the concessional regime offered to FIIs. Hence, in appropriate cases, where the FIIs fulfill the criteria laid down such as volume of trade, frequency of transactions, method of accounting etc, their income may be classified as business income. Such business income will not be taxable in India for FIIs investing from treaty countries, in the absence of a PE in India.

Though the ruling would be binding only on RBC, it would have a persuasive value in the case of other FIIs trading in Indian securities, especially derivatives.

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