BEFORE THE AUTHORITY FOR ADVANCE RULINGS (INCOME TAX)
NEW DELHI

22nd Day of March, 2010

PRESENT

Mr.Justice P.V.Reddi (Chairman)
Mr.J.Khosla (Member)

A.A.R. No.816 of 2009

Name & address of the applicant	:	**Royal Bank of Canada** Royal Bank Plaza, 200, Bay Street, Toronto, Ontario Canada M5J 2J5
Commissioner concerned	:	DIT(International Taxation), Mumbai
Present for the applicant	:	Mr. P.J. Pardiwalla, Sr. Advocate Ms. Preeti Goel, Advocate Mr. Samit Sawant, Mr. Bhavesh Malde of S.R. Batliboi & Co
Present for the Department	:	Mr. T.N. Chopra, Advocate Mr. Shivendra Kumar Singh, Advocate

R U L I N G
(By Hon'ble Chairman)

1. The applicant has raised the following three questions in this application for advance ruling under section 245Q (1) of IT Act, 1961:

1. Whether the profits/losses from futures and options contracts (derivative transactions) carried out on the Indian Stock exchanges are in the nature of "Business income" in the hands of the applicant under the provisions of the Act read with the Agreement for Avoidance of Double Taxation between India and Canada (Treaty)?
2. Whether profits/losses from transactions relating to purchase and sale of equity shares or other tradable securities on the Indian stock exchanges are in the nature of "Business Income" in the hands of the applicant under the provisions of the Act read with the Treaty?
3. Since the applicant does not have a permanent establishment (PE) in India as per Article 5 of the Treaty, whether "Business income" of the applicant (referred to in

the question 1 and 2 above) will not be taxable in India under Article 7(1) of the treaty?

2. Thus, two types of transactions are referred to in the application: The first category is profits earned/losses incurred from transactions in future contracts and option contracts traded on the stock exchanges. The second category is a proposed transaction, viz., the purchase and sale of shares and futures that are carried on as a part of an "index arbitrage activity".

3. The applicant is a public company incorporated under the Bank Act of Canada and is engaged in the business of banking and other financial services. It also trades in securities (including derivatives) in various parts of the world including India. In India, the applicant is registered as Foreign Institutional Investor (FII) with the Securities and Exchange Board of India ((SEBI) since March 2008 and is mainly dealing in the derivatives segment of the Indian Stock Exchanges, where stock/index futures and stock/index options are traded. To undertake derivative transactions the applicant has appointed Citi Bank, Mumbai as settlement agent and domestic custodian and transactions are executed on-line through the brokers registered with Stock Exchanges in India. The applicant also proposes to undertake purchases and sales of equity shares and other securities in the near future on the stock exchanges in India. It is stated that such purchase and sale of shares/securities on the Stock Exchanges would be carried out as a part of 'index arbitrage trading strategy' and would be for the purposes

of earning trading profits. It is claimed that the primary purpose of such activity would not be to purchase and hold shares/securities for the purpose of earning any dividend income, though some incidental dividend may arise. The index arbitrage trading is explained as involving simultaneous purchase (or sale) of equities and sale (or purchase) of index futures. Such activity seeks to capitalize on the difference (or spread) between equities and index future prices. It is stated that the books of accounts of the applicant are maintained in accordance with Canadian GAPP. Profits or loss arising to the applicant from dealing in futures and options and proposed dealing in shares/securities would be reflected as business profits in the financial statements and taxed accordingly in Canada. The applicant states that it has a representative office in India which is engaged in "preparatory and auxiliary activities relating to the core banking business". It is stated that the representative office does not play any role in the activities relating to derivative transactions and will also not play any role in relation to the proposed dealings in equity shares and other securities to be carried out in future.

3.1 It is explained in the application that 'Derivatives' are financial contracts which derive their value from the price of underlying instruments such as equity shares, treasury bills, commodities, foreign exchange etc. There are two types of exchange traded derivatives – futures and options. In a futures contract, parties agree to undertake to trade (buy or sell) securities at a stated price and quantity by using standardized contracts

on a stock exchange. At the time of entering into contract, no money changes hand. The Exchange may however insist on some margin money to be retained by the brokers of contracting parties. These contracts can be squared up anytime before the expiry date and it is at the time of squaring up the sum equal to profit (or loss) is received (or paid) through Stock Exchange. Mostly, the applicant has been trading in futures. 'Options', on the other hand, are contracts which give the right but not obligation to buy or sell the underlying assets at a stated date and at a stated price. A buyer of the option pays premium to buy the right to exercise his option. The seller (writer) of the option is the one who receives the option premium and is therefore obliged to sell or buy the asset if the buyer exercises his option.

3.2 As per the answers to Frequently Asked Questions (FAQ) given by NSE of India, Futures & Options Contract have a maximum trading cycle of 3 months.

4. The applicant submits that the derivative transactions undertaken by it are part of its trading activity. The object in purchasing derivative is to resell the same at appropriate time and earn income. Sometimes, the applicant sells derivatives first and then purchases them. Further, the number and the amount relating to these transactions are substantial and carried out at regular frequency. The applicant is stated to have undertaken more than 1000 derivative transactions during the financial

year 2008-09. It is on the basis of these facts, the applicants claims that the profits earned/or loss suffered by it from derivative transactions should be characterized as business profits or loss.

4.1 On the question of proposed activity of sale and purchase of shares/securities as part of index arbitrage trading activity, the applicant states that it would also be for the purpose of earning trading profits. It is claimed that shares/securities will not be held on long term basis. The applicant also expects to have trade volume of several hundred transactions per year with share volume in hundreds of thousands of shares having approximate value between 5 to 20 billion rupees. It is claimed that the income earned by the applicant by buying and selling of equity shares/securities from Indian Stock Exchanges would be in the nature of business income.

4.2 The applicant submits that it has no fixed place of business in India through which its business is fully or partly carried on. It does not have any branch or office in India. The representative's office of the applicant in India does not play any role in carrying out the transactions in derivatives etc. It is therefore submitted that the applicant has no permanent establishment (PE) in India and hence its business income from trading in derivatives, shares and other securities on Indian Stock Exchanges is not taxable in India in terms of the Article 7 of the DTAA[$] (Tax Treaty).

[$] Double Taxation Avoidance Agreement between India and Canada

5. The Revenue on the other hand, contends that under SEBI and FEMA Regulations, the applicant is only allowed to make 'investments' in the capital market in India; that the trading of derivatives on stock exchanges would also amount to an investment activity and the income earned from such an activity would not be business income but capital gains. According to Revenue's counsel, the FIIs, including the applicant, can operate in India only as investors and not as traders in securities. Therefore, any income earned by the applicant which is a FII[1] would be capital gain only in which it is liable to be taxed in India. The Revenue further contends that the applicant's income from dealing in derivatives/shares/securities has necessarily to be brought within the purview of section 115AD which is a self contained code applicable to the FIIs. It was argued that, for the FIIs, section 115AD contemplates income from dividend, interest and capital gains only. Therefore, the applicant could only have earned 'capital gains' from the transfer of securities which would be taxable in India under the provisions of section 115AD of the Income-tax Act, 1961 ('the Act').

6. The question is whether the income derived from the dealings in 'Derivatives' ought to be treated as capital gain or trading profit. The exchange traded derivatives are those which derive values from underlying securities which may be a particular asset (e.g. Reliance stock) or index (e.g NIFTY, NSC etc). Future contracts are entered into based on the value of the stock. Income is earned only on a settlement of

[1] Foreign Institutional Investor

transaction which could be either profit or loss. Income is derived from the transfer but not from the instrument and there will be no physical delivery of shares. Annexure-III to the Paper Book filed by the applicant shows a large number of transactions undertaken in the year 2008-09. The trading cycle will be of short duration, the maximum period being 3 months (vide answers given in the booklet of NSE of India).

7. The same question about the character of income relating to exchanged traded derivative contracts having a maximum of 3 months trading cycle has been considered by this Authority in the case of *Morgan Stanley & Co.*[2]. The facts noted in the said ruling are almost the same as in the present case. The following question was formulated in that case:

> "Whether the income derived by the applicant, a company incorporated in and tax resident of the UK, from trading in exchange traded derivative instruments in India would be taxable in India having regard to the provisions of the Double Tax Avoidance Agreement between India and UK?"

It was ruled that the income was not liable to be taxed in India having regard to the provisions of the DTAA between India and UK which provide that business profits can be taxed only if there is a permanent establishment. The contention of Revenue that the income was in the nature of capital gains was rejected. Several decisions of the Supreme Court starting from *Raja Bahadur Visveshwar Singh vs. CIT* (1961) 41 ITR 685 were referred to and the following passage in that case has been quoted:

[2] 271 ITR 416

> "(i) that if on the evidence which was before the Tribunal, i.e., the substantial nature of the transactions, the manner in which the books had been maintained, the magnitude of the shares purchased and sold and the ratio between the purchases and sales and the holdings, the Tribunal came to the conclusion that there was material to support the finding that the appellant was dealing in shares as a business, it could not be interfered with by the High Court."

7.1 After noting the features of 'derivatives' and adverting to the facts of the case, it was observed that the derivatives have a short life of about 3months and they do not yield any income like dividends and therefore investment of money with a view to derive any income was not feasible. Income can be derived only on their purchases and sales; so, they are held only as stock-in-trade. Further, it was noted that SEBI permitted the FIIs to trade in all exchange traded derivative contracts by its Circular of 12th Feb. 2002. Then, it was concluded :

> "We have perused the final details of derivatives traded between April 1, 2003 and March 31, 2004, which are on record. They indicate substantial nature of transactions, the magnitude of purchases and sales is enormous (amounting to Rs.3,932 crores in a year) and the ratio of purchases and sales is very high. On these facts, applying the principles noted above, it cannot but be said that the income from transactions of trading in derivatives is "business income" and not "capital gains".

7.2 Then, it was held after elaborate discussion that the applicant therein did not have any permanent establishment in India (PE) and therefore the business income cannot be taxed in India.

7.3 This ruling of the Authority has a direct bearing on the present case.

8. Reference has also been made by both sides on the later decision of this Authority in *Fidelity North Star Fund*[3] . There the question did not relate to the income from Derivatives. The question was whether profits from the sale of portfolio investments in India i.e. purchase and sale of shares and securities held for considerable time could be treated as business income. This Authority came to the conclusion that "the transactions are only in the nature of investment in capital assets to earn capital gains" and therefore liable to be taxed in India. The plea of the applicant that the transactions generated business income was not accepted. Apart from reiterating the principles laid down in the earlier ruling, the AAR relied on the dicta of Supreme Court in *CIT vs. Holck Larsen* (160 ITR 67) wherein the question was posed whether the conduct of the assessee was that of a dealer in shares or of an investor in shares. The opinion of Lord Reid in *J.P. Harrison's* case (40 TC 281) was quoted with approval.

> "The real question as Lord Reid said was not whether the transaction of buying and selling the shares lacks the element of trading, but whether the later stages of the whole operation show that the first step – the purchase of the shares – was not taken as, or in the course of, a trading transaction."

8.1 Thereafter, this Authority proceeded to consider whether the first stage i.e. the purchase of shares was not regarded as or in the course of a trading transaction. Thus, following Holck Larsen's case, the Authority gave primacy to the initial intention at the time of purchase of shares. Then the SEBI Regulations and Guidelines for 'foreign institutional

[3] 288 ITR 641

investors' (FIIs) and the Regulations under FEMA were referred to at length. In particular, Regulations 3 and 15 of SEBI (FII Regulations, 1995) were referred to. The following passages in that case deserve notice:

Regulation 3 reads thus :

> *"No person shall buy, sell or <u>otherwise deal</u> in securities as a foreign institutional investor unless he holds a certificate granted by the Board under these regulations. Then, it was observed :*
>
> *A close reading of the regulations, quoted above, particularly the portions underlined therein, on which reliance is placed by Mr. Desai, do not give any scope for reading in them the permission for training in securities. The expression "or otherwise deal in" in regulation 3(1) means other than buying and selling, e.g. lending/borrowing permitted under regulation 15(8) of the SEBI Regulations. It cannot be understood to mean doing business in securities because trading itself involves buying and selling and if it construed to mean trading as urged by Mr. Desai, the expression will become otiose.*

Then, it was observed :

> In our view it will be preposterous to impute an intention to FIIs, who responded to the offer of investment in securities in response to the guidelines, got themselves registered under the SEBI Regulations and undertook to abide by those regulations that they would, in the very first step itself, have intended to violate all the legislative requirements which provided them the opportunity to enter the capital marketing India. That the FIIs could not have intended to trade in the first step of purchase of shares, is also strengthened by the fact that in the income-tax returns filed by many of them, in consonance with the above legislative provisions, they have shown their income as capital gains."

9. Thus, the conclusion was reached by this Authority looking at the intention at the time of first purchase of the shares. The AAR proceeded on the premise that there was prohibition in law against trading in shares

and securities and therefore an intention could not be attributed to trade in shares. This ruling has been criticized on many counts by the learned senior counsel for the applicant, especially while dealing with the second question. As far as the first question with which we are concerned, *the ratio in Fidelity North Star Fund* has no application because this Authority was not concerned with Derivatives in that case. On the other hand, as far as Derivatives are concerned, there are categorical observations which support the contention of the applicant in the present case. That crucial passage is found at page 658 of ITR 288. "*It may be apposite to point out here that regulation 5(6) of the FEM Regulations (Security), 2000, specifically provides that a FII having approval under the FERA and the FEMA may trade in all exchange traded derivative contracts approved by SEBI. Further regulation 3 of the FEM Regulations (Derivative) 2000, prohibits that no person in India shall enter into a foreign exchange derivative contract without the prior permission of the Reserve Bank and accordingly the exchange traded derivative is specifically permitted. In contrast there is no provision in the aforementioned Acts, Regulations or Guidelines of the Government of India, permitting trading in other securities. The obvious inference is that trading in other securities is not permitted; in other words trading in securities other than exchange traded derivatives is prohibited."* These observations fully support the case of the applicant vis-à-vis the first question.

9.1 Apart from applying the test emphasized in *Holck Larsen* (supra), this Authority proceeded to discuss whether the criteria laid down in the earlier rulings (culled out from various Supreme Court decisions) have been satisfied in that case or not. The following observations made in this regard by the AAR may be noted :

> *The list contains purchases and sales in respect of Fund No. 339 which is said to relate to AAR No. 694/2006 - Fidelity Hastings Street Trust: Fidelity Discovery Fund. Pertaining to the year 2004 purchases of shares are in five companies which are noted at pages 107-109 and sales of shares in six companies are noted at pages 110-123. In regard to 2005 the purchases by the said fund relate to shares in two companies which are noted at page 124 and the sales transacted are noted from pages 125-133. The applicant, (in Paper Book-4), has submitted details of sales and purchases of shares of each trust for the period 2005-2006. They are reproduced in annexure 'B' to this ruling. Even on close scrutiny of the particulars mentioned in Annexure ' B' it has not been possible for us to co-relate the sales and purchases of shares. That apart, for the purpose of the application of the principles discussed above, we have no clue about the maintenance of the accounts by the applicants. From the accounts we would have been in a position to ascertain whether the shares have been entered therein as stock-in-trade or capital assets. Under the principle of accountancy the stocks-in-trade have to be valued at the end of each year in the case of trading to arrive at the profits of the business whereas in the case of investment in capital assets the gains can be determined only on the sale of such assets. In the case of Fidelity Advisor Series VIII [2004] 271 ITR 1 the Authority while laying down the aforementioned principles, noted the criteria to determine the said question. In spite of being aware of this position and even though the applicants are required to maintain such accounts under the SEBI Regulations, copies of the accounts maintained by them are admittedly not filed before the Authority to verify whether the requirements of the first principle is satisfied. In the absence of accounts we cannot but draw an adverse inference against the applicant, namely, had the accounts been produced before us they would have shown that the securities were not treated as stocks-in-trade but were treated as capital assets and that the investments in securities were for purpose of realizing capital gains. The ratio of sales and purchases are also not noted with reference to each applicant. The above discussion of the*

press note containing guidelines and various other provisions of different Acts and Regulations, at the least, raises a strong presumption that the transactions of purchases and sales of shares in Indian companies by the applicant are for realizing capital gains, which could have been rebutted by the applicant by producing all relevant records including accounts. It has to be borne in mind that the transactions of sales and purchases as stock-in-trade is a fact known to the applicant but it failed to produce necessary records including the accounts to satisfy the Authority that transaction is nothing but trading."

10. The learned counsel for the applicant has contended with considerable force that the factual position is quite different in the present case and the reasons which weighed with the Authority to reach the conclusion it did in the above passage do not apply here. The transactions of the applicant are of huge volume whereas there were only few transactions in *Fidelity North Star* case. Further, the revenues from Derivatives transactions have been treated in the instant case as trading revenue and the outstanding Derivative transactions are 'marked to market'. To substantiate this the relevant entries in the financial statements have been referred to. It has been brought to our notice that pursuant to the notice issued by the Department under Section 133(6) of the Act, the particulars relating to Derivatives contracts were placed before the Income tax authority. The basic facts referred to above have not been controverted. It is pointed out that the applicant has furnished all the material particulars and copies from the records unlike in the case of *Fidelity North Star* where the accounts and other evidence were not produced to show that the shares were being treated as stock-in-trade.

11. The learned counsel for the Revenue has found fault with the observations of this Authority in *Fidelity North Star* that there was no prohibition in law as far as the exchange traded derivatives were concerned. The Revenue's counsel has contended that under SEBI Regulations, only investments can be done and purchases of shares can only be on capital/investment account. Hence, irrespective of frequency and volume of the transactions and the expression 'trade' employed in, Regulation No.5(6) of the FEM (Transfer of issue of Security by a non-resident) Regulations, 2000, the word 'trade' is used in a generic sense and it shall be confined only to investment. We do not see any warrant to place such restriction on an expression of wide import especially in the context in which it is used. Secondly, Regulation No.3 of the FEM (Derivatives) Regulations, 2000 referred to by this Authority in *Fidelity North Star* case prohibits a person from entering into a foreign exchange Derivative contract without the prior permission of Reserve Bank. That the Reserve Bank permitted the Derivative contracts is not in dispute. Therefore, the observations of this Authority in regard to exchange traded derivatives cannot be faulted.

12. Coming to SEBI (FII Regulations 1995), Regulation 15 deals with 'Investment Restrictions'. Regulation 15(1) in so far as it is quoted below :

> ***Investment restrictions***
>
> ***15(1)*** *A foreign institutional investor may invest only in the following:*
>
> *(a) securities in the primary and secondary markets including shares, debentures and warrants of companies [unlisted],*

listed or to be listed on a recognized stock exchange in India; and

(b) units of schemes floated by domestic mutual funds including Unit Trust of India, whether listed on a recognized stock exchange or not, [units of scheme floated by a Collective Investment Scheme.]

(c) dated Government Securities;

(d) derivatives traded on a recognized stock exchange.

(e) Commercial paper

(f) Security receipts

12.1 On a contextual interpretation, the expression 'investment' has to be understood in a broad sense and in conjunction with the word 'traded on'. Investment in Derivatives does not necessarily exclude trading transactions. The expression 'commercial paper' following clause (d) (i.e. derivatives) indicates that even in respect of such items where the investment is not involved, is intended to be covered by Regulation 15. So also, the item in clause(f) i.e. 'security receipts' bear predominant characteristics of trade. We are therefore of the view that the Revenue's contention that there is a prohibition of trading in Derivatives under the FEMA or SEBI Regulations is unsustainable. The observations at page 658 of *Fidelity Northstar* to the effect that there is no prohibition as far as exchange traded derivatives are concerned, cannot be assailed for any valid reason.

12.2 We do not think that giving an undertaking in terms of SEBI Regulations would amount to an admission that the applicant is precluded from trading in Derivatives, as contended by the Revenue's counsel. Such undertaking to abide by Rules and Regulations have no bearing on the characterization of income. Another point made out by the learned counsel for the Revenue is that under the Bank Act of Canada, the

applicant cannot carry on business other than the business of banking. Reference is made to Section 409 and 410(2) of the Act. However, on a reading of the other provisions, the restriction is not absolute and the applicant has filed a letter dated 10th Feb. 2010 which states that the Bank Act permits Royal Bank of Canada to conduct proprietary training activities and that the Superintendent of Financial instructions is aware that the applicant conducts such training activities. Further, the minutes of the meeting of Board of Directors of Royal Bank of Canada held on 30.11.2007 shows that a resolution has been passed *inter alia* to purchase, sell, issue, underwrite and otherwise deal in securities (including equity and debt securities, options and futures).

13. What remains to be considered is Section 115AD on which the Revenue has placed strong reliance seeking support from certain observations made in *Fidelity North Star.*

13.1 Section 115AD bears the heading "Tax on income by foreign institution investors from securities or capital gains arising from their transfer". The relevant portion thereof is extracted below :

> ***Section 115AD***
>
> *(1) Where the total income of a foreign institutional investor includes-*
>
> *(a) income, other than income by way of dividends referred to in section 115-O received in respect of securities (other than unit referred to in section 115AB); or*
>
> *(b) Income by way of short-term or long term capital gains arising from the transfer of such securities,*
>
> *the income-tax payable shall be the aggregate of –*
>
> *(i) the amount of income-tax calculated on the income in respect of securities referred to in clause(a), if any, included in the total income, at the rate of twenty per cent;*

(ii) the amount of income-tax calculated on the income by way of short-term capital gains referred to in clause(b), if any, included in the total income, at the rate of thirty per cent;
Provided that the amount of income-tax calculated on the income by way of short-term capital gains referred to in section 111A shall be at the rate of fifteen per cent.

(iii) the amount of income-tax calculated on the income by way of long term capital gains referred to in clause (b), if any, included in the total income, at the rate of ten per cent; and

(iv) the amount of income-tax with which the foreign institutional investor would have been chargeable had its total income been reduced by the amount of income referred to in clause (a) and clause(d).

2. Where the gross total income of the foreign institutional investor-
(a) consists only of income in respect of securities referred to in clause(a) of sub-section(1), no deduction shall be allowed to it under sections 28 to 44C or clause (i) or clause (iii) of section 57 or under Chapter VIA.;

(c) includes any income referred to in clause (a) or clause (b) of sub-section(1), the gross total income shall be reduced by the amount of such income and the deduction under Chapter VIA shall be allowed as if the gross total income as so reduced, were the gross total income of the foreign institutional investor.

3. Nothing contained in the first and second provisos to section 48 shall apply for the computation of capital gains arising out of the transfer of securities referred to in clause (b) of sub-section(1).

Explanation : For the purpose of this section,-
(a) the expression "foreign institutional investor" means such investor as the Central Government may, by notification in the Official Gazette, specify in this behalf;
(b) *the expression "securities" shall have the meaning assigned to it in clause (h) of section 2 of the Securities Contracts (Regulation) Act, 1956 (42 of 1956)."*

13.2 The contention of the Revenue's counsel is that Section 115AD is a self-contained code and a special provision for charging to tax the income from securities in the case of FIIs. There cannot be any income outside Section 115AD as far as FIIs are concerned. Section 115AD contemplates FIIs deriving income only from dividend, interest and the like

and not business income. Cl.(a) of sub-section (1), according to the Revenue's counsel, connotes income from holding securities, i.e. dividend, interest, etc. like fruits from tree and is not intended to cover income on account of transfer of securities. In fact, there is a clear indication in the Section itself that the business income is not covered by the said section. It is pointed out that the very fact that deductions under sections 28 to 44 C are not allowed under sub-section (2) of Section 115AD is indicative of the fact that business income is not intended to be brought within the scope of cl (a) of sub-section (1). It is also pointed out that the applicant does not have a business place in India so as to generate business income. It is further contended that the expression 'income is received' necessarily excludes business profits. Another point made out is that if section 115AD is construed as including business income, it will be in the teeth of SEBI Regulations in asmuchas those regulations will be violated. The interpretation which results in such violation should be avoided.

13.3 None of the above contentions of Revenue based on Section 115AD have any force. It appears to us that the purpose and purport of Section 115AD is to provide for special or concessional rate of taxation in relation to securities received or arising from the income of FIIs. Two categories of income shall specify in the section. The income in clause (b) arises on account of transfer of securities; it may be short term or long term capital gains. The income in clause (a) is received "in

respect of securities"; however, it excludes income by way of dividends. It must be noted that the expression "in respect of" is of wide import, more or less synonymous with the expression ' in connection with' or ' in relation to'. There is no particular reason why the income on account of trading in securities is excluded from the purview of section 115AD. The fact that the transfer of securities giving rise to capital gains is dealt in clause(b) is not a valid reason that the transfer of securities in the course of trading in them is outside the ambit of section 115AD. The basic question to be addressed is about the characterization of income. It cannot be denied that the securities can be transferred as a part of trading activity. If so, the real question would be whether the resulted income should be more appropriately treated as trading profit or capital gains. As stated earlier, this raises the question of the correct classification or characterization of income. We find it difficult to subscribe to the view that clause(b) of sub-section(1) of section 115AD will be rendered otiose if income arising from the trading of securities is brought within the purview of clause(a). The contention that the income-tax laws does not contemplate a Foreign Institutional Investor deriving income on account of trading in securities because it is prohibited by the regulatory regime of SEBI and FEMA proceed on a wrong premise that there is such absolute prohibition against trading in securities. We have already referred to the relevant Regulations and the finding of this Authority that trading in derivatives is permitted and not prohibited under the said Regulations. There is no

warrant to place a restricted construction on clause(a) of sub-section(1) of section 115AD that only the income on account of holding the securities (like fruits from a tree) is covered by clause(a). If such restricted scope was intended to be given to clause(a), there should have been a more explicit language to that effect especially to counteract the effect of the wide expression ' in respect of'. The argument of the learned counsel for the Revenue that clause(a) of sub-section(2) which excludes the deduction admissible to business income a clear pointer that income on account of trading in all types of securities is not contemplated by section 115AD does not appeal to us. The obvious reason for enacting sub-section(2) is to ensure that the assessee (FII) shall not have enjoyed the double benefit of concessional rates as well as deductions. In fact sub-section(2) may militate against the contention of the Revenue because the said provisions has been inserted on the premise that the income under clause (a) of sub-section(1) can be in the nature of business income. Thus viewed from any point of view, we do not find any substance in the Revenue's arguments based on section 115AD.

13.4 There is yet another angle from which the issue can be viewed. Irrespective of the provisions of the domestic law i.e. IT Act, the applicant can also seek the benefit of the treaty provisions. If the income derived by the applicant can be characterized as business income rather than the capital gain, such income cannot be taxed in India in the absence of permanent establishment. If, on the other hand, the income is in the

nature of capital gains, the same is liable to be taxed under the IT Act. Thus the classification of income for the purpose of treaty is necessary. Such classification has to be done in accordance with the ordinary and well settled principles. A special provision in the Income-tax Act cannot be pressed into service to deny the benefit which is otherwise due to FII under the tax treaty provisions notwithstanding their conflict with the domestic law of income tax. Viewed from this perspective, we come back to the issue of characterization of income irrespective of section 115AD. The Revenue's argument is liable to be rejected for this additional reason also.

14. We are therefore of the view that the **first question** has to be answered in the affirmative. The **third question** in so far as it is related to question no. (1) is also answered in the affirmative. That means, the business income of the applicant arising from the 'derivative transactions' is not liable to be taxed in India by virtue of article 7(1) of the DTAA between India and Canada.

15. On the **second question** the ruling is sought on the proposed activity of purchase and sale of equity shares and other securities. It is the contention of the applicant that the income from these transactions should also be classified as 'business income' and not as 'capital gain. The nature of treatment of the transactions in the accounts would also indicate that it gives rise to business income but not capital gain. It is pointed out that this Authority has at least in 3 rulings viz. 250 ITR 194;

271 ITR 1 and 280 ITR 425 have held that the profits from the purchase and sale of shares were in the nature of business profits which were not liable to be taxed in the absence of permanent establishment. However, it is submitted that this Authority struck a different note in the case of *Fidelity North Star Fund (288 ITR 641)* referred to extensively earlier. Firstly, it is pointed out that the said ruling is distinguishable for the reason that the factual position in that case was quite different. Secondly, the decision in *Fidelity North Star Fund* is criticized by the learned counsel for the applicant on various grounds: (i) that the Authority erroneously proceeded on the premise that there was a prohibition against trading in shares and securities under the FEMA and SEBI Regulations; (ii) the reasoning is inconsistent; and (iii) the understanding of section 115AD is not correct.

15.1 Though there is some force in the contention advanced by the learned counsel, we are not inclined to give a ruling at this stage. We agree with the learned counsel for the Revenue that the question has to be decided on the basis of actual facts but not on hypothetical basis. No doubt, the advance ruling can be sought in respect of a transaction "proposed to be undertaken". But where the determination of the question depends on assessment of certain crucial facts, the actual pattern of dealings or the *modus operandi* of the transactions, it would not be appropriate to undertake the task of giving a definite ruling at this juncture, especially when we are called upon to reconsider the earlier ruling of this

Authority on the same issue. It may also be relevant to consider whether the actual modalities of the transactions have the attributes of index arbitrage trading or they are in the nature of hedging activity. The question can be answered depending on the actual state of affairs. We are therefore of the view that it would not be appropriate to give a ruling at this stage though there is no strict legal bar to do so. Therefore, we decline to answer the question. The applicant is at liberty to file a fresh application seeking ruling on this aspect at the appropriate time.

Accordingly, the ruling is given and pronounced on this the **22nd** Day of **March, 2010.**

sd/-	**sd/-**
(J.Khosla)	**(P.V. Reddi)**
Member	**Chairman**

F.No. AAR/816/2009 Dated: ----/03/2010

This copy is certified to be a true copy of the Ruling is sent to:-

1. The applicant.
2. The DIT (International Taxation), Mumbai.

(Batsala Jha Yadav)
Addl. Commissioner of Income-tax, AAR