*** IN THE HIGH COURT OF DELHI AT NEW DELHI**

Reserved on: 17.04.2014
Pronounced on: 25.04.2014

\+ **ITA No.485/2012**

RADIALS INTERNATIONAL ..... Appellant

Through: Mr. Kaanan Kapur, Advocate.

Versus

ASSTT. COMMISSIONER OF INCOME TAX ..... Respondent

Through: Mr. N.P. Sahni, Sr. Standing Counsel.

CORAM:
HON'BLE MR. JUSTICE S. RAVINDRA BHAT
HON'BLE MR. JUSTICE R.V. EASWAR

MR. JUSTICE S. RAVINDRA BHAT
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1. This is an appeal filed against the order of the Income Tax Appellate Tribunal ("ITAT") which upheld the action of the Revenue in treating the profit made by the appellant on sale of equity shares under the Portfolio-Management Schemes ("PMS") as business income and not as capital gains, as claimed by the appellant.

The question of law that arises for determination before the Court is: "*whether, the shares invested through a portfolio management*

scheme, in the circumstances of this case resulted in gains taxable as capital gains or as business income?"

2. The facts are that the Appellant (hereafter "assessee"), is a partnership firm, engaged in the business of providing technical, marketing and maintenance services for earth mover, aircraft and truck tyres. It also trades in tyres. For the assessment year 2006-07, the assessee had declared a total income of □3,17,80,943/- on 31.10.2006. The AO, after selecting the case for scrutiny assessment, found on 18.11.2008 that the gains realized by the assessee on sale of shares were in the nature of business income, and not capital gains. The assessee, in its reply to the AO stated that the shares were depicted as investments and not "stock in trade" in the accounts of the assessee and hence the gains resulting from their sale were to be considered capital gains. The assessee also attempted to produce evidence to show that the intention had not been to earn trading profit: *first*, the investment was undertaken by the assessee with its own surplus funds, and not borrowed funds, and *second,* that the holding period for a majority of the transactions was substantial. Moreover, the assessee sought to show that the relationship between the investor (the assessee) and the investment manager (the portfolio manager), as indicated by the agreements entered by Portfolio Management Schemes ("PMS"), was one of principal and agent. It was also sought to be shown that since the transactions made by the PMS were delivery based, where delivery of the scripts was taken/given on purchase/sale of shares (as reflected in the D-MAT account with the

NSDL), the transactions were intended as investments and not adventure in the nature of trade.

3. The AO held by its order dt. 30.10.2008 *first*, that a sum of □51,47,172/- was to be added as business income of the assesse (profits from trade less the PMS charges, treated as expenses wholly and exclusively for the purpose of business), *second*, that penalty proceedings under Section 271(1)(c) were to be initiated and *third*, that the claim for rebate under Section 88E, as an alternative, was to fail since no evidence of the Securities Transaction Tax paid was furnished. It was reasoned that the purpose of a portfolio manager was to optimize returns of the investor. Since the motive of the transactions was the earning of profit and not a dividend, where the holding period was ranging from a few days to a few months, it was concluded that the income was business income earned by way of adventure in the nature of trade

4. The Commissioner of Income Tax (Appeals) ("CIT(A)")held that the intention at the time of purchase and sale, the magnitude and frequency of transactions has to be seen to test whether the sum of gain made *"was a mere enhancement of value by realizing a security"* or a *"gain made in operation of business in carrying out a scheme for profit-making"*. It was concluded that the shares were not in the nature of property which yielded any income or personal enjoyment to the owner, by virtue solely of its ownership. Thus, the intention was concluded to be profit-making, and the gains were found to be business income.

5. The ITAT upheld the order of the CIT(A), and found the gains to be *"business income"*. It held that the nature of a PMS agreement is that it *"prevents holding of dormant of stocks of depreciating value"*, and that the PMS is supposed to *"provide the skill and expertise to steer through the complex volatile and dynamic conditions of the market"*. The order may be extracted in relevant part:

> *"10. Under PMS a person deposits the money under the contract for a period normally not less one year. After depositing the money the investment in securities is left to the choice of the portfolio manager. The assessee has no control either on selecting the securities or the period of holding. The portfolio manager normally gives the account quarterly on the basis of which the investor comes to know about the profit earned and the securities in which the transactions were done by the port Folio manager on behalf of the assessee. The shares purchased and sold are credited and debited to the DEMAT account of the party, which remains in the control of portfolio manager. It is the portfolio manager who can only deal with the DEMAT account of a particular person. At the time of depositing the amount the assessee will definitely make entry in his books of account as investment in PMS. But he is not aware of the transactions in the shares being entered into by the portfolio manager on his behalf as his agent. The portfolio manager charges his fee for the services rendered and other expenses incurred on the same lines as is done in a case where the agent charges from his principal. Since the assessee comes to know about the purchase and sale of shares in the PMS after the expiry of a period of three months, the accounting treatment in the books of the assessee in respect of shares purchased/sold by the portfolio manager under PMS cannot be entered in the books of the assessee. It is at the end of the year the shares available in the DEMAT account can be entered. <u>Therefore, at the time of deposit</u>*

> *of amount, the intention of the assessee was to maximize the profit. The purchase and sale of shares under PMS was not in the control of the assessee at all. Therefore, it cannot be said that the assessee had invested money under PMS with intention to hold shares as investment. The portfolio manager has carried out trading in shares on behalf of his clients to maximize the profits. Therefore it cannot be said that shares were held by the assessee as investment.*
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> *13. ... Merely because the purchase and sale of shares had occurred through DEMAT account on delivery based; it would no change the nature of the transaction. Since the portfolio manager in the capacity of an agent has traded in shares on behalf of the assessee, the profits arising therefrom, will be in the nature of business profits. Further simply because the assessee has treated the deposits made under PMS as investments and balance shares lying in DEMAT account as on the last day of the accounting year under the head 'investment' would not change the character of trading done by the portfolio manager on behalf of the assessee. The shares purchased and sold during the year have not been recorded in the books of accounts as investment nor is it feasible to record as the details were not available with the assessee and the assessee has no control or say as to when and the type of shares or the period of holding of the shares. Therefore in our considered opinion, the transactions are in the nature of business. The decision relied upon by the assessee in the case of Gopal Purohit (supra) is not applicable to the facts of the assessee's case."*

6. The ITAT also observed that the frequency of sale and purchase of shares indicated trading activity. Finally, the ITAT observed that the principle of *res-judicata* is not applicable in Income Tax proceedings and therefore, the argument that the AO was barred from taking a view different from his earlier view was untenable in law.

Since the ITAT found that the gains were taxable as business income, the exemption of section 10(38) for long term capital gains for shares held longer than 12 months, as well as the claim for concession at the rate of 10% under section 111A on short term capital gains were both denied.

7. Counsel for the Appellant argued that the transactions must be considered by themselves, while applying the tests to determine whether they are investments or adventure in the nature of trade. It is urged that the PMS agreement, by its terms alone or by the fact of agency being handed over to the portfolio manager, cannot be the basis for inferring an intention to profit or that the transactions are in the nature of trade. The Revenue, on the other hand, emphasizes that the fee paid to the broker is more than the return on the property, thus indicating that the portfolio management scheme itself is one intended to earn profit. Of the total of 1248 transactions that have taken place in the relevant period, the Counsel urges that there were on average, about 4-5 transactions daily, only 8 of which entailed a holding period of longer than 365 days. Thus, it is urged that the order of the Ld. ITAT must be upheld.

8. This Court has considered the submissions of both parties. At the outset, it would be pertinent to note some of the relevant terms of the PMS agreement. Clauses 7(b) and 7 (c) of the PMS agreement between Radial and Kotak Securities Ltd. indicate that only in a discretionary portfolio, unlike in a non-discretionary portfolio, the manager has full discretion to invest in respect of the client's account in any type of security, and make such changes in the investments as

he deems fit. Clause 18 (b) of the agreement states that the manager shall

> *"not be responsible for any loss or expenses resulting to one person as client, from the insufficient or deficiency of value of or title to any property or security acquired or taken on behalf of the client".*

While the agreement entered into between Radial and Reliance appears to be a discretionary portfolio, as indicated in clause 9 (by which client "unconditionally and irrevocably" grants power of attorney to the portfolio manager to make decisions on the investments), clause 10 states that the portfolio manager provides no warranty as to the appreciation of the securities in which he applies the client's funds. Therefore, it is clear that a PMS agreement can be an instrument by complete authority and discretion over the transactions to be entered into, is surrendered to the portfolio manager by the investor.

9. From the terms of the agreement it does not emerge that the intention of the investoris to make profits. The terms on the other hand, indicate that regardless of the level of discretion handed over to the portfolio manager, there is neither any guarantee that the securities invested in will appreciate nor is the portfolio manager responsible to the client for any loss from the deficiency of value of the securities. Thus, the PMS agreement at best, embodies the intention to appoint an agent with limited liability, who will invest on behalf of the investor and nothing more.

10. The Ld. ITAT reasons that "*at the time of deposit of amount, the intention of the assessee was to maximize the profit"* because *first,* while the assessee enters the PMS as investments in the books of account at the time of depositing the money, the assessee does not know what specific transactions will be entered into by the manager, *second,* that the assessee finds out the details of the transactions only after three months have expired and, only at the end of the year can the shares in the DEMAT account be entered into the books of account, *third,* the assessee has no control over the shares bought or sold under the PMS and thus the portfolio manager enters into transactions on behalf of his clients to maximize profits. From this, the ITAT infers that "*it cannot be said that the assessee had invested money under PMS with intention to hold shares as investment*".The reasoning of the Ld. ITAT does not find favour with this Courtfor three reasons.

11. *First,* the three reasons provided by the ITAT merely convey that intention to hold shares as investment cannot be inferred from the agreement. However, the fact that no inference of an intention to invest can be made from the agreement does not translate to the intention to trade in shares for profit either. As was noted in *Raja Bahadur KamakhyaNarain Singh v. CIT-Bihar,* (1969)3SCC791 = (1970) 77 ITR 253 (SC) :

> *"The surplus realised on the sale of shares, for instance, would be capital if the assessee is an ordinary investor realising his holding; but it would be revenue, if he deals with them as an adventure in the nature of trade. The fact that the original purchase was made with the intention to*

> *resell if an enhanced price could be obtained is by itself not enough but, in conjunction with the conduct of the assessee and other circumstances, it may point to the trading character of the transaction. For instance, an assessee may invest his capital in shares with the intention to re-sell them if in future their sale may bring in higher price. Such an investment, though motivated by a possibility of enhanced value, does not render the investment a transaction in the nature of trade.*

12. As indicated here, while a transaction may be motivated by the intention to resell at an enhanced value, it would not be possible to evaluate whether the transaction was actually in the nature of trade, until the securities are actually resold. Moreover, in a discretionary PMS, it becomes all the more relevant and necessary to evaluate the intention of the assessee in conjunction with his conduct and other circumstances, since the intention of the *assessee* cannot be ascertained at the time of depositing the money in the investment, because the actual sale and purchase of securities happens at the hands of the portfolio manager, a mere agent.

13. *Second*, since the intention of the assessee cannot be ascertained, and the investments are made by the portfolio manager without the knowledge of the assessee/investor in a discretionary PMS, the manner in which the securities have been treated by the assessee can and ought to be evaluated only post the fact of investment, and not at the time of depositing the money. This proposition is supported by the judgment of the Supreme Court reported as *CIT-Calcutta v. Associated Industrial Development*

Company, AIR 1972 SC 445 = (1971) 82 ITR 586 (SC), in which it was held that:

> *"…it was open to the assessee to contend that even on the assumption that it had become a dealer and was no longer an investor in shares the particular holdings which had been cleared and the sales of which had resulted in the profit in question had always been treated by it as an investment. It can hardly be disputed that there was no bar to a dealer investing in shares. But then the matter does not rest purely on the technical question of onus which undoubtedly is initially on the revenue to prove that a particular item of receipt is taxable. Whether a particular holding of shares is by way of investment or forms part of the stock-in-trade is a matter which is within the knowledge, of the assessee who holds the shares and it should, in normal circumstances, be in a position to produce evidence from its records as to whether it has maintained any distinction between those shares which are its stock-in-trade and those which are held by way of investment.*

The assessee can only show that the holdings in question were always treated as an investment (despite having made a profit on clearing them) post the fact of investment. It would also be necessary to acknowledge that the characterization of a transaction, i.e as a portfolio management scheme or investment, itself is not determinative. It is settled law that nomenclature of a document or deed is not conclusive of what it seeks to achieve; the court has to consider all parts of it, and arrive at a finding in regard to its true effect (Ref. *Puzhakkal Kuttappu v. C. Bhargavi & Ors* AIR 1977 SC 105 and *Faqir Chand Gulati, Appellant(s) V. Uppal Agencies Pvt. Ltd* 2008 (10) SCC 345). In the income tax law, the position is no

different, as can be seen from the judgment of the Supreme Court in *CIT Vs. Motors & General Stores (P) Ltd.* (1967) 66 ITR 692 (SC), following *Duke of Westminister* (1935) 19 Tax Cas. 490 and *Commissioner of Inland Revenue Vs. Wesleyan & General Assurance Society* (1948) 16 ITR (Supp.) 101.

14. *Lastly,* the way in which the tests are to be applied was made clear in the CBDT Circular no. 4 of 2007, which states:

> *"8. The Authority for Advance Rulings(AAR) (288 ITR 641), referring to the decisions of the Supreme Court in several cases, has culled out the following principles :-*
> *(i) Where a company purchases and sells shares, it must be shown that they were held as stock-in-trade and that existence of the power to purchase and sell shares in the memorandum of association is not decisive of the nature of transaction;*
> *(ii) the substantial nature of transactions, the manner of maintaining books of accounts, the magnitude of purchases and sales and the ratio between purchases and sales and the holding would furnish a good guide to determine the nature of transactions;*
>
> *(iii) ordinarily the purchase and sale of shares with the motive of earning a profit, would result in the transaction being in the nature of trade/adventure in the nature of trade;but where the object of the investment in shares of a company is to derive income by way of dividend etc. then the profits accruing by change in such investment (by sale of shares) will yield capital gain and not revenue receipt.*
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> *…*
> *11. Assessing Officers are advised that the above principles should guide them in determining whether, in a given case, the shares are held by the assessee as investment (and therefore giving rise to capital gains) or as stock-in-trade (and therefore giving rise to business*

> *profits). The Assessing Officers are further advised that no single principle would be decisive and the total effect of all the principles should be considered to determine whether, in a given case, the shares are held by the assessee as investment or stock-in-trade.*

15. It was also held in *P.M. Mohammed Meerakhan v CIT-Kerala,* (1969)2SCC25 = (1969) 73 ITR 735 (SC) :

> *"…it is not possible to evolve any single legal test or formula which can be applied in determining whether a transaction is an adventure in the nature of trade or not. The answer to the question must necessarily depend in each case on the total impression and effect of all the relevant factors and circumstances proved therein and which determine the character of the transaction.."*

16. Therefore, it is legally untenable to focus singularly on the intention or motive of the assessee without looking at the substantial nature of the transactions, in terms of their frequency, volume, etc.

17. This Court thus concludes that:

a. The PMS Agreement in this case was a mere agreement of agency and cannot be used to infer any intention to make profit

b. The intention of an assessee must be inferred holistically, from the conduct of the assessee, the circumstances of the transactions, and not just from the seeming motive at the time of depositing the money

c. Along with the intention of the assessee, other crucial factors like the substantial nature of the transactions,

frequency, volume etc. must be taken into account to evaluate whether the transactions are adventure in the nature of trade

18. Therefore the block of transactions entered into by the portfolio manager must be tested against the principles laid down, in order to evaluate whether they are investments or adventures in the nature of trade.

19. Coming to the facts of this case, it is not contested that the source of funds of the assessee were its own surplus funds and not borrowed funds. This Court notices from Annexure 4 (p. 90) that the following is the volume of transactions on the basis of holding period.

Period of holding	**< 90 days**	**90-180 days**	**181-365 days**	**>365 days**	**Total**
Quantity of shares	32,750	18,063	38.140	90.649	179,602
Percentage to total quantity	18.23%	10.06%	21.24%	50.47%	
Gain or loss	236,121.87	803,149.68	2,446,125.84	2,217,955.77	5,723,353.16
Percentage of CG/L to total CG/loss	4.12%	14.03%	43.09%	38.75%	

20. It is clear thus, that about 71% of the total shares have been held for a period longer than 6 months, and have resulted in an accrual of about 81% of the total gains to the assessee. Only 18% of the total

shares are held for a period less than 90 days, resulting in the accrual of only 4% of the total profits. This shows that a large volume of the shares purchased were, as reflected from the holding period, intended towards the end of investment. This Court is not persuaded by the argument of the Revenue that an average of 4-5 transactions were made daily, and that only eight transactions resulted in a holding period longer than one year. This is because the number of transactions per day, as determined by an average, cannot be an accurate reflection of the holding period/frequency of transactions. Moreover, even if only a small number of transactions resulted in a holding for a period longer than a year, the number becomes irrelevant when it is clear that a significant volume of shares was sold/purchased in those transactions.

This Court is thus of the opinion that the Ld. ITAT erred in holding the transactions to be income from business and profession. The order of the ITAT is consequently set aside and the appeal is answered in favour of the assessee.

S. RAVINDRA BHAT
(JUDGE)

R.V. EASWAR
(JUDGE)

APRIL 25, 2014