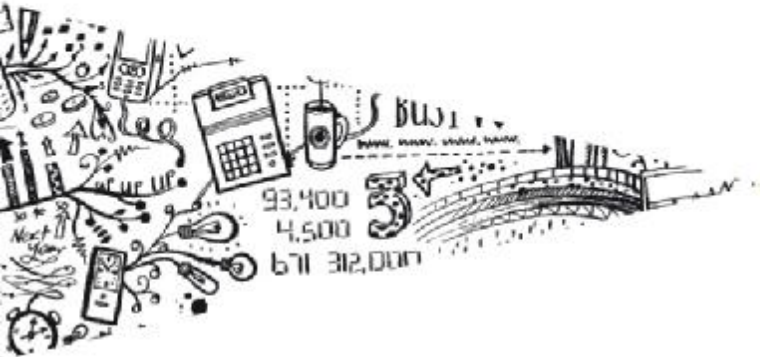


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EY Tax Alert

Pune ITAT rules portfolio management fees deductible in computing capital gains



Executive summary

This Tax Alert summarizes a recent ruling of the Pune Income Tax Appellate Tribunal (ITAT) in the case of the KRA Holding & Trading (P) Ltd. (ITA Nos. 500,1320/PN/08, 434/PN/09) and ARA Trading & Investments (P) Ltd. (ITA Nos. 499,1321,1322/PN/08,806/PN09) (collectively referred to as 'Taxpayers') on the issue of deductibility of portfolio management fees in computing 'capital gains' under the Indian Tax Laws (ITL). The ITAT observed that such fees were directly connected to the acquisition and sale of securities and were incurred in the normal course of the investment activity. It was held that the payments would be allowed as a deduction in computation of capital gains under the ITL.

Background and facts

- ▶ Section 48 of the ITL (Section) provides for the mode of computation of capital gains. From the full value of consideration, deduction is allowed in respect of (i) expenditure incurred 'wholly and exclusively' in connection with such transfer and (ii) the cost of acquisition as well as cost of improvement of the asset transferred.
- ▶ The Taxpayers had engaged ENAM Asset Management P. Ltd. (ENAM) for portfolio management services. For the relevant tax year, the ITAT had concluded that the Taxpayers had securities which were held as investments and were capital assets. Accordingly, any income earned by the Taxpayers from sale of such

securities was in the nature of 'capital gains' under the ITL.

- ▶ During the same tax year, the Taxpayers had paid certain fees to ENAM for the portfolio management services (Fee). The Fee was paid on the termination of period of agreement with ENAM which was subsequently renewed and it was computed on the basis of the Net Asset Value (NAV) on the date of termination of period of agreement. The Taxpayers were of the view that the Fee was paid in connection with the acquisition/sale of securities and claimed the above as a deduction in computation of capital gains for the tax year.
- ▶ The Tax Authority disallowed the claim by classifying the Fee as a 'profit sharing fee'. It contended that such Fee was in violation of the Regulatory Guidelines^[1] (applicable to portfolio managers) which prohibited portfolio managers from charging fee on a return sharing basis. The first appellate authority also dismissed the appeal of the Taxpayers.
- ▶ Aggrieved by the order, the Taxpayers appealed before the ITAT.

Issue for consideration

Whether fees paid by the Taxpayers for portfolio management services would be allowed as a deduction while computing capital gains under the ITL?

^[1] SEBI (Portfolio Managers) Rules & Regulations, 1993

Tax Authority's contentions

- ▶ For the purposes of capital gains, each asset is to be considered on a standalone basis and computation of cost of acquisition should be asset specific. Hence, there is a need for identification of the asset specific expenditure. The Fee paid to ENAM is not asset specific as it is based on the NAV on the termination date of period of the agreement.
- ▶ Reliance was placed on a recent decision of the Mumbai ITAT in the case of Davendra Kothari ^[2] on a similar issue wherein the fee paid to portfolio managers was not allowed as a deduction while computing capital gains under the ITL.
- ▶ Under the ITL, no deduction is permitted in respect of expenditure which is in infringement of any law.

Taxpayers' contentions

- ▶ The Section allows deduction of any expenditure incurred wholly and exclusively in connection with transfer. It is the real income, i.e. the actual income that reaches the taxpayers ^[3], which should be taxable.

^[2] [136 TTJ 188]

^[3] Rajkot Dist Gopalak Co-op Milk Products Union v CIT [204 ITR 590]

- ▶ Reliance was placed on the decision of the jurisdictional High Court (HC) of Mumbai in the case of CIT v Shakuntalal Kantilal ^[4] to contend that if the genuineness, certainty and necessity of a payment is beyond doubt, such a payment is deductible even in the absence of specific enabling provisions of computation of capital gains. The deduction is computed either by taking full value of consideration as net of the payments or deducting the same as expenditure incurred wholly and exclusively in connection with transfer.
- ▶ The decision of Mumbai ITAT in the case of Davendra Kothari, as relied by the Tax Authority, was distinguishable for the following reasons:
 - ▶ The taxpayer could not explain the basis of calculation and allocation of the portfolio management fees. Such fees were calculated based on not only the global turnover reported by the portfolio manager, but also the dividend income. Such basis was unscientific.
 - ▶ The taxpayer had failed to discharge the onus of proving that the fees paid to the portfolio manager were incurred wholly and exclusively in connection with the transfer of the securities.
- ▶ The Regulatory Guidelines have now been amended to allow portfolio managers to charge fee on a profit sharing basis. Hence, the payment of such fee is not infringement of law.
- ▶ As per Accounting Standard 13 (AS 13), while accounting for investments, cost of an investment includes acquisition charges like brokerage, fees and duties. The Supreme Court (SC) in the case of UP State Industrial Development Corporation^[5] adjudicated on the issue of loading the underwriting commission to the cost of acquisition of shares picked up by the underwriter in the event of under subscription by public. The SC has held that profits and gains under the ITL should be computed as per the ordinary principles of commercial accounting, if such principles are not in conflict with any express provision of the ITL.
- ▶ The expression 'in connection with transfer' as used in the Section is wider than 'for the transfer' and would necessarily include any payment which is absolutely necessary to effect the transfer.
- ▶ A genuine, necessary and undisputed expenditure cannot be denied, even in absence of express provisions in the Section.
- ▶ Under the ITL, while computing capital gains, a deduction is allowed for expenditure incurred 'wholly and exclusively' in connection with the transfer. Reliance was placed on the SC decision in the case of Sasoon J David & Co P Ltd. v CIT^[6] wherein the twin adverbs of 'wholly' and 'exclusively' were explained stating that 'wholly' refers to the quantum of the expenditure, the sum of money spent and 'exclusively' has reference to the 'purpose' behind the expenditure and 'not the motive or object' of expenditure.
- ▶ The Fee paid to ENAM is in accordance with the AS13 and the method of accounting consistently followed by the Taxpayers. The SC in the case of UP State Industrial Corporation (*supra*) has held that general principles of accounting have to be observed under the ITL. Furthermore, once the liability to incur is certain, the difficulty of quantification does not bar the Taxpayers from claiming expenditure specifically if the basis of quantification is scientific and reasonable.

In the present case, the Fee is based strictly on the NAV of the securities and not with reference to dividends or other miscellaneous income. Thus, the Taxpayers have successfully demonstrated direct nexus of the Fee to the acquisition and sale of the securities.

ITAT's ruling

- ▶ Scope of the Section is laid down in the decision of the jurisdictional HC of Mumbai in the case of CIT v Shakuntalal Kantilal (*supra*). The HC held that:
 - ▶ The 'full value of consideration' includes both additions as well as deletions from the apparent value. Accordingly, the 'full value of consideration' means real and effective consideration after allowing the deductible expenditure.

^[4] [190 ITR 56]

^[5] [225 ITR 703]

^[6] [118 ITR 261]

- ▶ The decision of the Mumbai ITAT in the case of Davendra Kothari was distinguishable on facts and it did not refer to the interpretation of the Section given by the Mumbai HC in CIT v Shakuntalal Kantilal (*supra*).
 - ▶ The argument of the Tax Authority that expenses are not asset specific could not be accepted, since in matters involving securities, fee paid to portfolio manager is never asset/security specific. Payment is for composite services and is incurred for the twin purpose of acquisition and transfer of securities. Furthermore, the amended provisions of the Regulatory Guidelines allowed the payment of a fee to portfolio managers on profit sharing basis.
 - ▶ The Fee paid to ENAM for the portfolio management services was directly connected to the securities and its transfer and was genuinely incurred as bona fide payments necessary in the normal course of the investment activity. In view of the binding decision of the jurisdictional Mumbai HC in the case of Shantilal Kantilal (*supra*), such expenditure is deductible under the Section.
- on the ruling of a jurisdictional HC clarifies the issue considerably. While admitting the deductibility of portfolio management fees, the ITAT acknowledges the general principles of deductibility like direct nexus, allocation of expenditure, reliance on accounting principles etc.

Comments

This favorable ruling of the ITAT is helpful in support of claim for deduction of portfolio management fees in the computation of capital gains under the ITL. The ruling comes as a relief for taxpayers as it has duly considered a contrary ruling of the Mumbai ITAT on the subject. The present ruling of the ITAT which relies

Our offices

Ahmedabad

2nd floor, Shivalik Ishaan
Near CN Vidhyalaya Ambawadi
Ahmedabad - 380 015
Tel: + 91 79 6608 3800
Fax: + 91 79 6608 3900

Bengaluru

"UB City", Canberra Block
12th & 13th floor
No.24 Vittal Mallya Road
Bengaluru - 560 001
Tel: + 91 80 4027 5000
+ 91 80 6727 5000
Fax: + 91 80 2210 6000 (12th floor)
+ 91 80 2224 0695 (13th floor)

Chennai

TPL House, 2nd floor
No. 3 Cenotaph Road Teynampet
Chennai - 600 018
Tel: + 91 44 6632 8400
Fax: + 91 44 2431 1450

Hyderabad

205, 2nd floor
Ashoka Bhoopal Chambers
Sardar Patel Road
Secunderabad - 500 003
Tel: + 91 40 6627 4000
Fax: + 91 40 2789 8851

Oval Office, 18, iLabs Centre
HITECH City, Madhapur
Hyderabad - 500081
Tel: + 91 40 6736 2000
Fax: + 91 40 6736 2200

Kochi

9th Floor, Abad Nucleus
NH-49, Maradu PO
Kochi -682304
Tel: +91 484 3044000
Fax: +91 484 2705393

Kolkata

22 Camac Street
Block 'C', 3rd floor
Kolkata - 700 016
Tel: + 91 33 6615 3400
Fax: + 91 33 2281 7750

Mumbai

14th floor, The Ruby,
Dadar, Mumbai - 400 028.
Tel: + 91 22 6192 0000
Fax: + 91 22 6192 1000

6th Floor, Express Towers,
Nariman Point,
Mumbai - 400 021
Tel: + 91 22 6657 9200
Fax: + 91 22 2287 6401

Block B-2, 5th Floor
Nirlon Knowledge Park
Off. Western Express Highway
Goregaon (E), Mumbai - 400 063.
Tel: + 91 22 6749 8000
Fax: + 91 22 6749 8200

NCR

Golf View Corporate Tower B
Near DLF Golf Course Sector 42
Gurgaon - 122002
Tel: + 91 124 464 4000
Fax: + 91 124 464 4050

6th floor, HT House
18-20 Kasturba Gandhi Marg
New Delhi - 110 001
Tel: + 91 11 4363 3000
Fax: + 91 11 4363 3200

4th & 5th Floor, Plot No 2B, Tower 2,
Sector 126, NOIDA 201 304
Gautam Budh Nagar, U.P. India
Tel: + 91 120 671 7000
Fax: + 91 120 671 7171

Pune

C-401, 4th floor Panchshil Tech Park
Yerwada (Near Don Bosco School)
Pune - 411 006
Tel: + 91 20 6603 6000
Fax: + 91 20 6601 5900

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