IN THE HIGH COURT OF JUDICATURE AT BOMBAY

ORDINARY ORIGINAL CIVIL JURISDICTION

WRIT PETITION NO.866 OF 2010

The Prudential Assurance Company Ltd.,
a company incorporated in the United
Kingdom and having its correspondence
address in India at C/o.Prince water house
Coopers (P) Ltd., Plot No.18/A, Guru
Nanak Road, Bandra (W), Mumbai – 50 ..Petitioner.

Versus

1. The Director of Income-tax
(International Taxation), 1st Floor,
Room No.107, Scindia House,
N.M. Road, Ballard Estate,
Mumbai – 400 038

2. The Union of India,
through the Secretary,
Ministry of Finance, North Block,
New Delhi – 110 001 ..Respondents.

Mr.Percy J. Pardiwala, senior Advocate with Mr.R. Murlidharan and Mr.P.C. Tripathi i/by Mr.Atul K. Jasani for the petitioner.

Mr.Suresh Kumar for the respondents.

CORAM : Dr.D.Y. Chandrachud &
J.P. Devadhar, JJ.

DATE : 29 April 2010.

ORAL JUDGMENT (Per Dr.D.Y. Chandrachud, J.)

1. Rule. With the consent of the learned counsel appearing on behalf of the petitioner and the learned counsel appearing on behalf of the Revenue, the petition is taken up for hearing and final disposal. Counsel for the respondents waives service.

2. The petitioner is a company incorporated in the United Kingdom and is engaged in the business of insurance. The petitioner is registered as a sub-account of a Foreign Institutional Investor (FII) with the Securities and Exchange Board of India. The dispute in this case relates to assessment years 2004-2005 and 2005-2006. On 30 April 2001, the Authority for Advance Rulings (AAR) constituted under Section 245 of the Income Tax Act, 1961 held that the purchase and sale of shares by the petitioner was in the ordinary course of its business and the income which resulted from this, constitutes business profits and not capital gains. One of the issues which the ARR addressed was whether the gains arising from realization of portfolio

investments in India would be treated as part of business profits and would hence be covered by the provisions of Article 7 of the Agreement of Avoidance of Double Taxation and Prevention of Fiscal Evasion with Respect to Taxes on Income and Capital Gains entered into between the Governments of India and of the United Kingdom. On this question the AAR held that gains arising from the realization of portfolio investments in India would be treated as part of the company's business profits. The AAR also came to the conclusion that the amounts receivable by the petitioner from share transactions in India would not be taxable in India because the petitioner did not have a permanent establishment in the country. The AAR ruled that investments in shares were carried out by the petitioner from moneys collected from policy holders for the purpose of generating profits so that it can fulfil its commitments. This not being a case of capital gains, the AAR held that the provisions of Article 7 would apply and profits earned from the sale of shares in India would not be liable to tax in India as business income.

3. From assessment year 1999-2000 until 2005-2006, assessments were made under Section 143(3) by Assessing Officers. For assessment year 2004-2005, the petitioner filed a return of income, disclosing an income of Rs.8,91,280/- by way of income from other sources. The profits on the sale of shares were claimed not to be chargeable to tax. On 22 March 2007, the Assessing Officer issued a notice under Section 148 proposing to reopen the assessment. The ground on which the assessment was sought to be reopened

was that the contention of the assessee, "that the income arising to it is in the nature of business income is contrary to the judicial decisions in similar cases and that it had been held that the income arising on the share transactions would have to be treated as in the nature of capital gains".

During the course of the proceedings before the Assessing Officer, details were sought from the petitioner and an enquiry was held. The petitioner was inter alia called upon to explain by a letter dated 22 October 2007 as to why the activity of the sale and purchase of shares should be regarded as trading activity and not as an investment. The petitioner responded by a reply dated 7 November 2007 and submitted a note containing its comments on the position of law as to whether income generated in India constituted capital gains or business income. The petitioner also relied upon the ruling of the AAR in the case of *Fidelity Advisors Series VIII*[1]. After considering the explanation of the petitioner, the Assessing Officer passed an order of assessment under Section 147 read with Section 143(3) for assessment year 2004-2005. The returned income of the petitioner was accepted in view of the ruling of the AAR in the case of the petitioner.

4. During the course of assessment year 2005-2006, the Assessing Officer, as part of the inquiry, called upon the petitioner by a letter dated 25

1 271 ITR 1

July 2007 to submit comments on the position of law as to whether the income of FII's in India would be capital gains or business income with reference to the latest judicial decisions. In response to the letter, the petitioner in a communication dated 8 August 2007 stated that as part of its insurance business it engaged in the business of buying and selling securities. A copy of the order passed by the AAR was annexed to the letter together with an explanatory note on the question as to whether income generated by FII's in India would constitute capital gains or business income on the basis of recent judicial pronouncements. The Assessing Officer, during the course of the assessment proceedings, called upon the petitioner by a letter dated 31 October 2007 to make further disclosures and to explain as to why the petitioner should not be considered as having a permanent establishment in India and to state as to why the activity involving the sale and purchase of shares should be regarded as trading activity and not as investment. The petitioner responded on 16 November 2007. An order of re-assessment under Section 143(3) for the assessment year 2005-2006 was passed on 28 December 2007.

5. The dispute before the Court in these proceedings arises out of a notice issued by the Director of Income Tax (International Taxation) on 18 March 2010, calling upon the petitioner to show cause as to why the assessments for assessment years 2004-2005 and 2005-2006 should not be set aside under Section 263 on the ground that they are erroneous and

prejudicial to the interests of the Revenue. The basis on which the Director of Income Tax (International Taxation) has formed an opinion that the assessment orders were liable to be revised under Section 263 is that the AAR, in its ruling in the case of Fidelity Northstar Fund held that the profits derived on account of purchase and sale of equities would constitute capital gains and would be chargeable to tax accordingly. At this stage, it would be relevant to extract from the notice issued under Section 263, which reads thus:

> "2. It is seen from the assessment orders that the profit on account of purchase / sale of equities was held as "business income" by the Assessing Officer as per the AAR's Ruling in your case in AAR No.445/98. The AAR in its recent Ruling in the case of Fidility Northstar Fund in AAR No.678/2006 has held that the profits derived on account of purchase and sale of equities is "capital gains" and chargeable to tax accordingly. It has also been observed by the AAR that FIIs are not permitted to trade in equities. In view of this, the subsequent ruling of the AAR which clarifies the position on the subject as to the taxability of and nature of income is applicable to the facts of your case. Accordingly the provisions of Sec. 245S(2) are clearly applicable to your case for A.Ys. 2004-05 and 2005-06 and the profits derived on account of purchase / sale of shares is chargeable to tax as "capital gains".

6. In assailing the invocation of the jurisdiction under Section 263, counsel appearing on behalf of the assessee relied upon the provisions of Section 245S, under which a Ruling rendered by the AAR is binding on the Applicant who has sought it; in respect of the transaction in relation to which the ruling had been sought; and on the Commissioner, and income-tax authorities subordinate to him, in respect of the applicant and the said

transaction. Counsel urged that under sub-section (2) of Section 245S, an advance ruling shall be binding unless there is a change in law or facts on the basis of which the advance ruling has been pronounced. The submission that was urged before the Court was that the Assessing Officer had followed the binding ruling of the AAR in the assessee's own case. The Commissioner, it was urged, would not be justified in seeking recourse to the jurisdiction under Section 263, where the Assessing Officer has followed a binding ruling issued under Section 245S. It has also been urged that the ruling in the case of Fidelity Northstar Fund could not constitute a change in law for the purposes of Section 245S(2).

7. On the other hand, it has been urged on behalf of the Revenue that : (i) At this stage, only a notice has been issued to the petitioner under Section 263 and there is no reason for this Court to exercise its extra ordinary jurisdiction under Article 226 of the Constitution; and (ii) The Central Board of Direct Taxes had in a Circular dated 15 July 2007 directed the Assessing Officers to evaluate whether, in a given case, 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) having regard to the pronouncement of the AAR in the subsequent case. The Assessing Officer not having done so, it was urged that the Commissioner was justified in seeking recourse to his revisional jurisdiction under Section 263.

8. Chapter XIX-B of the Income Tax Act, 1961 was introduced with effect from 1 June 1993 by the Finance Act of 1993. The chapter makes a provision for advance rulings and constitutes an authority, presided over by a retired Judge of the Supreme Court. The expression 'advance ruling' is defined in clause (a) of Section 245N to mean (i) a determination by the Authority in relation to a transaction which has been undertaken or is proposed to be undertaken by a non-resident applicant; or (ii) a determination by the Authority in relation to the tax liability of a non-resident arising out of a transaction which has been undertaken or is proposed to be undertaken by a resident applicant with such non-resident; and (iii) a determination or decision by the Authority in respect of an issue relating to computation of total income which is pending before any income-tax authority or the Appellate Tribunal and such determination or decision shall include the determination or decision of any question of law or of fact relating to such computation of total income specified in the application.

Section 245S stipulates that an advance ruling pronounced by the Authority under Section 245R shall be binding only on (a) The Applicant who had sought it; (b) In respect of the transaction in relation to which the ruling had been sought; and (c) On the Commissioner, and the income-tax authorities subordinate to him, in respect of the applicant and the said transaction. In other words, upon an advance ruling being rendered under Section 245R, the ruling binds the applicant, the Commissioner and the

authorities subordinate to him and the ruling would apply to the transaction in relation to which it was sought. Sub-section (2) of Section 245S postulates that the ruling shall be binding unless there is a change in law or facts on the basis of which the advance ruling has been pronounced. The rules which have been made under Section 245V regulate the procedure before the Authority. These rules which are called the Authority for Advance Ruling (Procedure) Rules, 1996 inter alia deal with the modification of an order passed by the Authority. Rule 18 provides that where the Authority suo motu or on a representation made to it by the applicant or the Commissioner or otherwise, but before the ruling pronounced by the Authority has been given effect to by the Assessing Officer is satisfied, that there is a change in law or facts on the basis of which the ruling was pronounced, it may by order modify such ruling in such respects as it considers appropriate, after allowing the applicant and the Commissioner a reasonable opportunity of being heard.

Once a ruling has been pronounced by the Authority, the binding effect of the ruling can only be displaced in accordance with the procedure which has been stipulated in law. At this stage, it would also be necessary to note that under Section 245T, where the Authority finds, on a representation made to it by the Commissioner or otherwise, that an advance ruling pronounced by it has been obtained by the applicant by fraud or misrepresentation of facts, the Authority may may declare such ruling to be void *ab initio* and thereupon all the provisions of the Act shall apply to the

applicant as if such advance ruling had never been made, after excluding the period beginning with the date of such advance ruling and ending with the date on which the order under Section 245T has been passed.

9. The sole basis on which the Commissioner invoked the jurisdiction under Section 263 is that the Authority had in its ruling in the case of Fidelity Northstar Fund held that the profits derived on account of the purchase and sale of equities are capital gains and are chargeable to tax accordingly. The Commissioner notes that in that ruling the Authority held that FIIs are not permitted to trade in equities. According to the Commissioner, the subsequent ruling of the AAR which clarifies the position on the subject as to the taxability of and the nature of income would be applicable to the facts of the petitioner's case. Hence, it has been held that the provisions of Section 245S(2) are applicable to the case of the petitioner for assessment years 2004-2005 and 2005-2006 and the profits derived on account of the purchase / sale of shares would be chargeable to tax as capital gains.

There is merit in the submission which has been urged on behalf of the petitioner that the Commissioner has manifestly exceeded his jurisdiction in relying upon the ruling of the AAR in the case of Fidelity Northstar Fund as a ruling which would apply to the petitioner. Ex-facie, Section 245S shows that a ruling of the AAR binds the Applicant, the

Commissioner and the income-tax Authorities subordinate to him and shall apply in relation to the transaction in which the ruling was sought. The ruling rendered in the case of Fidelity Northstar Fund by AAR cannot bind the petitioner nor can it displace the binding effect of the ruling rendered in the case of the petitioners. There is no dispute before this Court that the transaction in respect of which the petitioners sought a ruling and in respect of which the AAR had issued a ruling to the petitioners is of the same nature as that for assessment years 2004-2005 and 2005-2006. Evidently, the Commissioner has ignored the clear mandate of the statutory provision that a ruling would apply and be binding only on the Applicant and the Revenue in relation to the transaction for which it is sought. The ruling in Fidelity cannot possibly, as a matter of the plain intendment and meaning of Section 245S displace the binding character of the advance ruling rendered between the Petitioner and the Revenue.

That apart, the Commissioner could not possibly have found fault with the Assessing Officer for having followed a binding ruling. Where the Assessing Officer has followed a binding principle of law laid down in a precedent which has binding force and effect, it is not open to the Commissioner to exercise his revisional jurisdiction under Section 263. This principle was laid down in a judgment of the Calcutta High Court in ***Russell Properties Private Limited V/s. A. Choudhury, Additional Commissioner of***

Income Tax, West Bengal[2]. In that case, the Tribunal had come to the conclusion in respect of certain previous years, following the decision of the Supreme Court in the case of ***Karnani Properties Limited V/s. Commissioner of Income Tax***[3], that receipts received by tenants for the maintenance of service charges were assessable under the head of business income and not assessable under the head 'property'. The Tribunal on examining the facts of the case found that they were identical to those before the Supreme Court. Following the decision of the Tribunal, the Income Tax Officer proceeded to assess such income under the head 'business'. The Commissioner then sought to invoke his jurisdiction under Section 263 on the ground that such income should have been assessed to tax under the head 'property' since in respect of the previous year a reference was pending before the High Court. The Calcutta High Court held that the Income Tax Officer had merely followed the decision of the Tribunal. No error had been pointed out in the decision of the Income Tax Officer nor was it pointed out that there was material for the Assessing Officer not to follow the decision of the Tribunal. The Calcutta High Court observed that whenever there is a decision of a higher appellate authority, the subordinate authorities are bound to follow the decision if judicial discipline is to be maintained. Recourse to the jurisdiction under Section 263 was, therefore, held not to be warranted. The judgment of the Calcutta High Court has been followed by a Division Bench of this Court in ***Commissioner of Income-tax V/s. Paul***

2 (1977) 109 I.T.R. 229 (Cal.)
3 (1971) 82 ITR 547 (S.C,)

Brothers[4] and by a Division Bench of the Gujarat High Court in ***Rajan Ramkrishna V/s. Commissioner of Wealth Tax, Gujarat – I***[5].

10. For the aforesaid reasons, we are of the view that on both counts the invocation of the jurisdiction under Section 263 was improper. Firstly, the Commissioner has ex-facie made a determination contrary to the plain language of Section 245S when he holds that the ruling of the AAR in the case of Fidelity Northstar Fund would apply to the case of the assessee. Unless the binding ruling in the case of the petitioner is displaced by pursuing requisite procedures under the law, that ruling must continue to operate and be binding between the petitioner and the Revenue. Secondly, and in any event, the Commissioner could not have possibly come to the conclusion that the view of the Assessing Officer was erroneous or that it was prejudicial to the interests of the Revenue when the Assessing Officer has followed a binding ruling of the AAR. The assessment order which gives effect to a binding precedent, in this case of the AAR, cannot be regarded as being erroneous or as being prejudicial to the interests of the Revenue. Since the invocation of the jurisdiction was not proper, the petitioners should not be relegated to pursue the proceedings initiated under Section 263.

11. We would clarify, in conclusion, that we have had no occasion having regard to the nature of the jurisdiction that was invoked by the

4 (1995) 216 ITR 548 (Bom.)
5 (1981) 127 ITR 1 (Guj.)

Commissioner to inquire into the correctness of the ruling of the AAR in the case of the petitioner and we leave it open to the Revenue to take recourse to such remedies in law in respect of the ruling of the AAR, if so advised.

12. Rule is accordingly made absolute by quashing and setting aside the impugned notice dated 18 March 2010. In the circumstances of the case, there shall be no order as to costs.

(J.P. Devadhar, J.) (Dr.D.Y. Chandrachud, J.)