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INDIRECT TRANSFER OF SHARES IN AN INDIAN COMPANY | SINGAPORE SHAREHOLDER HELD TO BE NOT TAXABLE IN INDIA

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The Income Tax Appellate Tribunal (Tribunal), Delhi bench in the case of *Augustus Capital Pte Ltd [2020] (120 taxmann.com 325)* (Taxpayer) ruled that the capital gain arising on transfer of shares of a Singapore company holding Indian assets is not taxable in India on the basis that the small shareholder exemption claimed by the taxpayer applies retrospectively from 1 April 1961.

Background

Section 9(1)(i) of the Income-tax Act, 1961 (IT Act) as amended vide Finance Act, 2012 with retrospective effect from 1 April 1961, provides that income arising to a non-resident on transfer of any share or interest in a foreign entity shall be subject to tax in India if such share or interest derives its value substantially from assets located in India (indirect transfer tax).

Subsequently, an explanation was introduced vide Finance Act, 2015, which clarified that the share or interest in a foreign entity shall be deemed to derive its value substantially from Indian assets if on the specified date, the value of such Indian assets exceeds INR 100 million and represents at least 50% of total value of assets owned by the foreign entity (substantial value test).

It was also clarified that indirect transfer tax shall not be applicable for small-scale investors who either individually or with their related parties (at any time within 12 months preceding the date of transfer) do not (a) hold more than 5% of the total voting power or share capital or interest in the foreign entity that holds Indian asset and (b) hold any right of management or control in the foreign entity that holds an Indian asset (small shareholder exemption). If the foreign target entity is holding Indian asset indirectly then these conditions needs to be tested with respect to the foreign target entity as well as foreign entity that is holding the Indian asset directly.

In the instant case, the Taxpayer, a company incorporated in Singapore made investments in Accelyst Pte Ltd, another company incorporated in Singapore holding investments in India. In Financial Year (FY) 2014-15, the Taxpayer sold its entire shareholding in Accelyst Pte Ltd to an Indian company, namely Jasper Infotech Private Limited. The Taxpayer primarily relying on the small shareholder exemption claimed that this transfer was not taxable in India.

However, the tax officer denied the small shareholder exemption on the basis that said exemption is effective from FY 2015-16 prospectively and therefore, it would not be applicable to FY 2014-15 i.e. the year under consideration. While the Taxpayer also appears to have referred to the provisions relating to substantial value test, there is no discussion on whether the shares transferred derived more than 50% value from India. Aggrieved with the tax officer's order, the Taxpayer filed its objections before the Dispute Resolution Panel which were dismissed on the basis that IT Act does not expressly provides for small shareholder exemption to be applicable on retrospective basis. The Taxpayer accordingly filed further appeal before the Tribunal.

Ruling

The Tribunal ruled in favour of the Taxpayer by holding that provisions relating to substantial value test and small shareholder exemption have been inserted 'for the purpose of' indirect transfer tax provisions which are applicable retrospectively (1 April 1961) and therefore, the Taxpayer is entitled to the small shareholder exemption for the share transfer undertaken in FY 2014-15.

In arriving at this conclusion, the Tribunal strongly relied on the decision of the Hon'ble Delhi High Court in the case of *Copal Market Research Limited (Writ Petition No. 2033 of 2013)*, passed prior to the introduction of substantial value test. The Delhi High Court had held that gains on sale of shares of a company incorporated outside India, deriving less than 50% of its value from India is not taxable in India, based on (a) the recommendation of Shome Committee report (which was yet to be implemented) and (b) provisions under Article 13(4) of India-Korea tax treaty, OECD Model Tax Convention and the United Nations Model Double Taxation Convention, wherein the source country can tax gain on alienation of shares / interest in the entities, the property of which consists 'principally' of immovable property situated in that source country – 'principally' here has been defined to mean 50% of the aggregative value of total assets owned by the relevant entity.

The Tribunal further noted that the provisions relating to substantial value test and small shareholder exemption were introduced in view of the ambiguities raised by the taxpayers and the recommendation of the Shome Committee. As per the memorandum to Finance Bill, 2015, the Shome Committee recommendations were considered and a number of them (either in full or with partial modifications) were accepted for implementation either by way of an amendment of the IT Act or by way of issuance of a clarificatory circular in due course. Subsequently, the Central Board of Direct Taxes issued a Circular 41 of 2016 for giving clarifications on indirect transfer tax provisions.

Accordingly, the Tribunal concluded that since the 'substantial value test' and 'small shareholder exemption' have been inserted in furtherance of the object of 'indirect transfer tax provisions', which is applicable retrospectively from 1 April 1961, the provisions relating to 'substantial value test' and 'small shareholder exemption' should also be given retrospective effect.

Comments

This is indeed a welcome ruling and provides much needed clarity with respect to transfer of shares or interest in an entity outside India undertaken prior to introduction of substantial value test and small shareholder exemption. The Tribunal has provided quite a logical reasoning for the provisions relating to substantial value test and small shareholder exemption to be retrospective in nature, in the absence of which, the determination of substantial value test could be made on an arbitrary basis. Similarly, the shareholders holding a minor stake in a foreign company could have been subject to tax in India though transfer of such stake may effectively not result in a transfer of asset situated in India.

Interestingly, though the provisions relating to substantial value test have been referred to in this ruling, the Tribunal's conclusion of transaction not being taxable in India appears to be primarily on account of applicability of small shareholder exemption. It is noteworthy that indirect transfer tax is not applicable for all the non-residents (including those eligible for small shareholder exemption) if the substantial value test is not met.

Further, while the Taxpayer in this case was determined to be exempt from indirect transfer tax under IT Act itself, non-residents may also evaluate the exemption available, if any, under the applicable tax treaty.

Lastly, whether the tax authorities would resonate with the Tribunal's ruling or challenge this before the High Court, should be watched closely.

- *Sanjay Sanghvi (Partner), Rahul Jain (Principal Associate) and Sakshi Mehta (Associate)*

For any queries please contact: editors@khaitanco.com

Mumbai
One Indiabulls Centre, 13th Floor
Tower 1 841, Senapati Bapat Marg
Mumbai 400 013, India

T: +91 22 6636 5000
E: mumbai@khaitanco.com

New Delhi
Ashoka Estate, 12th Floor
24 Barakhamba Road
New Delhi 110 001, India

T: +91 11 4151 5454
E: delhi@khaitanco.com

Bengaluru
Simal, 2nd Floor
7/1, Ulsoor Road
Bengaluru 560 042, India

T: +91 80 4339 7000
E: bengaluru@khaitanco.com

Kolkata
Emerald House
1 B Old Post Office Street
Kolkata 700 001, India

T: +91 33 2248 7000
E: kolkata@khaitanco.com